Supreme Court of the United States

October Term, 1949.

No. 55.

MANUFACTURERS TRUST COMPANY, as Trustee under an Indenture made by the Debtor under date of September 27, 1933, and individually,
Petitioner,

vs.

REGINE BECKER, EMILY K. BECKER and WALTER A. FRIBOURG,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit.

BRIEF OF RESPONDENTS.

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Statement of the Case.

Petitioner's "Statement of the Case" is distorted and incomplete. It by no means conveys an accurate or fair picture of the events and transactions which form the subject matter of the instant appeal. Moreover, it attempts to place these events and transactions against a setting of over-reaching and wrongdoing for which, as we will show, there is not the slightest basis in fact. It will be sufficient

to mention at this point that after months of hearings and the eliciting of over 500 pages of testimony and the introduction of almost a hundred exhibits, Referee Olney, in a comprehensive series of findings of fact, dismissed these charges of wrongdoing as totally devoid of merit. His findings (R. 69-78) contain a much more complete and accurate review of the evidence than is to be found in petitioner's brief. And Judge Goddard, by affirming Referee Olney's order (R. 91-95), also found that there was no basis whatsoever for the petitioner's charges. In the Court of Appeals for the Second Circuit, both the prevailing and dissenting opinions (R. 176-188) are in accord on the point that there was here no suppression of information, wrongdoing or inequitable conduct. Judge Swan, who wrote the prevailing opinion, found, to the contrary, that the conduct of the respondents "was obviously very beneficial * * *" (R. 180).

It would seem to be clear beyond dispute that, in view of General Order 47 of the General Orders in Bankruptcy and Rule 52(a) of the Federal Rules of Civil Procedure, these findings of fact are now conclusive and may not be reargued on this appeal. Indeed, petitioner virtually concedes as much on page "12" of its brief where, acknowledging the binding force of these findings, it states that "as the matter is factual, the contention (of wrongdoing and inequitable conduct) is not pressed in this Court". Notwithstanding this concession, however, petitioner proceeds to present in its brief a sketchy review of the evidence and to reargue its contentions made in the courts below that this evidence establishes its charges of wrongdoing and inequitable conduct. The justification assigned for rearguing the adverse findings made against it is that "a brief reference to this phase of the case is necessary for a better understanding of the entire situation, and more particularly of certain comments in the two

opinions in the Court of Appeals". If this Court is to be asked by petitioner to consider evidence in addition to the legal questions involved, then we think the Court is entitled to have a fair, accurate and complete summary of the facts. Accordingly, we now present such a summary, all of which will be found to be supported by appropriate references to the printed record, the typewritten transcript and the numerous exhibits.

Before proceeding with our recital of the facts, we think the Court's attention should be called to the printed record submitted by the petitioner on this appeal. It is by no means a complete record of this litigation. Under the rules of the Court of Appeals for the Second Circuit, each party prints only such portion of the record as it desires, though the entire record in typewritten form is filed with the Clerk of the Court. The record now before this Court contains only those portions of the typewritten transcript which were printed for the Court of Appeals. Since, in this brief, we will be obliged to make references to portions of the record contained in the stenographic transcript but not in the printed appendices, we will, whenever we refer to testimony or exhibits in such stenographic transcript, identify such matter by appropriate references to the particular pages in the stenographic minutes where such testimony or other data appears. Such references will be labeled 'S.M.'

We should also state that in referring to petitioner's exhibits we shall designate them as 'Objector's' exhibits, since that is the way they are described in the printed record. The Findings will be identified by the letter F.

The Facts.

This appeal arises in a proceeding for arrangement filed by the debtor under the provisions of Chapter XI of the Bankruptcy Act.

Concededly, nothing in Chapter XI nor in any case decided under that statute authorizes or permits the filing by creditors of an application to limit the claims of other creditors to the amounts paid in acquiring such claims.

Furthermore, though petitioner in filing its objections did so in its individual capacity as an alleged creditor for $1,587.50, as well as in its capacity of Indenture Trustee, it remains the fact that petitioner's claim mentioned is still under objection and has not yet even been allowed by the Referee; also that nothing in the indenture instrument (Objector's Exhibit 28) grants any authority to petitioner to appear or file any claim in the bankruptcy proceeding —much less to file any objections to the claims of other creditors (*In re Indiana Flooring Co.*, 53 Fed. [2d] 263, and cases cited on p. 265). It is significant that though there are several hundred of such creditors, not one of them saw fit to file objections to the claims of the respondents or to join in the objections presented by the petitioner.

At the very outset it should be noted that none of the three respondents ever were officers or directors of the debtor corporation. The respondent Walter Fribourg is a friend of Norman and Sanford Becker, both of whom were directors of the debtor corporation, and the respondents Regine Becker and Emily K. Becker are respectively the mother and wife of Sanford Becker. None of these three respondents ever had the slightest connection with the management or operation of the affairs of the debtor corporation. They made their purchases with their own funds and for their own benefit, and neither of the so-called insiders, Norman and Sanford Becker, put up any money nor participated in such purchases in any way. They have not the slightest financial interest in these transactions. The respondent Fribourg was an experienced businessman and an investor in different types of securities and he undoubtedly had sufficient knowledge

concerning the debtor's property and the probable value of its bonds to form his own independent judgment as to the desirability of investing in such bonds (R. 111-112). The Becker ladies made their purchases because they had been advised by Norman Becker that, in his opinion, the purchase of the debtor's bonds at the prices at which they were available in the open market was a good speculation since—if the history of World War I was repeated, an inflationary spiral in real estate was likely to occur again after the termination of World War II—in which case these bonds might appreciate in value. Though petitioner's brief is replete with suggestions and innuendos that these three respondents profited by so-called "inside information" in purchasing their bonds, there is not the slightest justification for such a contention, as the findings of Referee Olney clearly establish. The value of the debentures purchased by the respondents depended in the final analysis upon the value of the apartment house in New Rochelle, which constituted the sole asset of the debtor corporation. Any debenture holder, or in fact any other person interested in the matter, could make just as intelligent a guess as to what this property would ultimately be liquidated for as could the respondents or the directors.

All of the bonds acquired by the three respondents were purchased months and years before the property was finally sold—some of them as much as three years before such sale—and not even petitioner dares assert that when these bonds were being purchased any of the respondents or even the Becker brothers, the so-called insiders, knew or could know when the debtor's property would finally be sold or what price would be realized therefor. None of these bonds were purchased after the filing of the petition for arrangement in the Court below or in contemplation of the filing of such petition, or at a time when the

debtor corporation itself was able to buy or was in the market to purchase its own securities (S. M. 497-498).

The debtor's property in New Rochelle, according to all of the testimony in the record, had been badly constructed and the building had been a losing venture from the time it was built (Resp. Exhibit 23, R. 155-157). During the depression of 1929 this property had been reorganized and the holders of the first mortgage certificated bonds were required to accept the income debenture bonds issued by the debtor corporation, which took over the property in the reorganization. These debentures were subordinated behind a new first mortgage placed on the property running to the Poughkeepsie Savings Bank, which mortgage went into default almost immediately after it was placed. The debenture bonds which were issued in this reorganization are the bonds which are involved in the instant appeal and they constituted practically the whole indebtedness of the debtor corporation in the arrangement proceeding. They never earned enough income to warrant the payment of any interest and at all times after they were issued they sold in the over-the-counter market at extremely depressed prices, at no time exceeding 8% (Resp. Exhibit 1, R. 142). Neither the three respondents nor Sanford and Norman Becker had anything whatever to do with the original company which owned and constructed the building, nor did they have anything to do with the reorganization that resulted in transferring the building to the debtor corporation. Their first connection with the debtor's affairs came in 1941 (more than four years before the arrangement proceeding in the Court below) when respondent Fribourg purchased some of the debenture bonds of the debtor corporation in the open market, and Sanford Becker bought some in the same way. These debenture bonds were actively traded in on the over-the-counter market.

Very few of the bonds here involved were acquired from so-called public investors.

The greater portion of the bonds were purchased directly from parties who were themselves officers and directors of the debtor corporation and who had been such for a longer period than Norman and Sanford Becker, and all of whom approached the respondents with an offer to sell. One of these, Richard Kelly, the President and a Director of the debtor corporation, was a lawyer of vast experience and the counsel for one of the large savings banks in New York City (S. M., 477) who owned $8,250 of bonds; another, Hays, owning $8,500 of bonds, was a member of the New York Stock Exchange; a third, Clay, was the financial adviser of the Young Women's Christian Association which owned $7,550 of the bonds. Still another block amounting to $37,500 was acquired from the King Estate, represented by the law firm of Reynolds, Richards and McCutcheon, one of whose partners, Mr. Minor, was on the Board of Directors. The testimony detailing the negotiations which resulted in these sales will be found at pages 106-108; 123-124; 131-140 of the record. That all of these officers and directors who sold their securities, had full and complete knowledge of the affairs, operations and property of the debtor corporation, was overwhelmingly established (See Resp. Exs. 7, 8, 9, 10, 11, 16, 17, 22, 23, ~~24,~~ 25, 25b, 25e and 29; R. 146-164; see also Findings 44, 47, 50 and 51, R. 76-77). Even petitioner concedes at page 13 of its brief that these parties knew they were selling their bonds to the respondents.

The remaining bonds (with the exception of 12 purchases totaling $15,750 face amount made by the respondent Fribourg on the so-called Winter offer) were all acquired by purchase in the open market through various brokerage firms (Obj. Exs. 11, 12 and 13, R. 62). It will be noted that included in the sellers were such experienced

and well known firms as Goldwater & Co., Reilly & Co., Shaskan & Co., Foster & Adams, Kissel Kinticutt & Co., and Sondheimer & Co. In every instance these brokerage firms sold as principals for their own account, as is the practice in the over-the-counter market (See Obj. Ex. 19—not printed). Obviously, these purchases from the brokerage houses were made on a completely impersonal basis and without any representations or discussions.

One of the paradoxes of this case is that, concededly, there would have been no salvage whatever for any of the debenture holders of the debtor corporation had it not been for the act of the respondents which petitioner assails, viz: that through their corporation Baset Realty Corp., respondents provided the debtor corporation in 1943 with $15,000 in order to avert an impending foreclosure of the first mortgage held by the Poughkeepsie Savings Bank, in the amount of $162,000. This act petitioner charges was for the purpose of placing "effective control of the situation" in the Beckers. The actual facts, however, are quite different, as will be seen from what follows. The directors of the debtor corporation had reached the end of their rope at that time and there seemed to be nothing left to do but to permit the equity of the debenture holders to be wiped out in a foreclosure sale (See Resp. Exs. 6, 11, 15, 22, 23, 24, R. 145-157). With the $15,000 then provided to the debtor corporation by the respondents for which they received a second mortgage, the arrears on the first mortgage were paid off; the property was saved and held until 1946 when it could be sold for a fair price. Though every other bondholder of the debtor corporation was afforded an opportunity to participate in this second mortgage, no one saw fit to do so (Obj. Ex. 9, R. 164-165). Even when this second mortgage went into default in 1943, and the respondents could have foreclosed it and wiped out all other debenture holders, they not only did not do so but they advanced additional sums

totaling $7,941.63 to meet taxes on the property (S. M. 417-419; 491). Through this honorable action on their part, the respondents saved the property for all the debenture holders and thereby made possible the ultimate sale of the property in 1946 for $300,000, which was sufficient to pay the debenture holders 43.61% on the dollar.

During the entire period covered by this review, the petitioner as Indenture Trustee did absolutely nothing to protect the interests of the debenture holders or to save the property from foreclosure by either the first mortgagee or the second mortgagee. It, nevertheless, throughout all this period demanded payment of its fees as Indenture Trustee, and when the property was finally sold by the debtor corporation it demanded that the proceeds of the sale be turned over to it for administration and distribution. It is an entirely reasonable conclusion that the refusal of the directors of the debtor corporation to meet this demand, on the advice of counsel, and their decision to have the fund administered through an arrangement proceeding in the Federal District Court, was responsible for the antagonistic and hostile position which the petitioner then assumed towards the respondents.

Review of Petitioner's Discussion of the Facts at Pages 5-14 of Its Brief.

It is here that petitioner has presented the distorted and grossly unfair picture adverted to at the beginning of this brief. We will comment briefly on the various topics included in petitioner's criticism.

1. **Re insolvency of debtor:** Petitioner at page four of its brief attempts to make it appear that the debtor corporation was at all times insolvent, both in the bankruptcy and in the equity sense, between 1941 and 1946

and was in no sense a "going concern" as that term is used in the cases cited by Judge Goddard in his opinion (R. 91-95). The undisputed facts are otherwise. The debtor corporation was formed in 1933 and though it was more or less constantly behind in payments on its mortgages and bills incurred in operating its property, all of such obligations were paid in full. Of course, the debtor was a "going concern". It owned and operated a large apartment house in New Rochelle for the whole period between 1933 and 1946. It bought supplies and fuel; it hired painters to decorate the apartments, and plumbers to take care of the heating system and other plumbing installations; for a time it operated a bus to take tenants to the railroad station; it hired managing agents; it paid taxes and interest on mortgages, all of these payments aggreating perhaps $600,000 or more. All this went on for a period of 13 years and no creditor who dealt with the debtor corporation in all that time has failed to receive full payment. How, in the face of these facts, it can be seriously urged that the debtor was not a going concern within the meaning of that clause as used by Judge Goddard and in the cases cited by him, is difficult to understand.

The situation here presented is analogous to that existing in *Upright* v. *Brown*, 98 Fed. 2d 802 (1938) where Judge Augustus N. Hand writing the opinion of the Court of Appeals for the Second Circuit said (p. 804):

> "While the company was from time to time financially embarrassed it was not proposing to wind up, and there was a reasonable probability that it would weather the storm. *Dill & Collins Co.* v. *Morrison*, 159 App. Div. 583, 144 N. Y. S. 894; *Drewen* v. *Union Discount Co.*, 2 Cir., 32 F. 2d 691, 693."

With respect to the question of bankruptcy insolvency, these are the facts: The debtor corporation on the reorganization of the property in 1933 issued $254,450 of income debentures maturing on September 27, 1953. No interest was payable on these debentures unless earned. It is this debt for $254,450 which existed when the petition for arrangement was filed in the Court below. Manifestly, if we consider the value of the debtor's property throughout the whole period here involved, viz. 1941-1946, to have been no more than the property brought on the sale held in 1946, then there is, of course, bankruptcy insolvency. But this property was assessed by the City of New Rochelle for $421,630 (see Obj. Ex. 10, not printed). Its cost was greatly in excess of that amount. The total unpaid indebtedness of the debtor corporation was only the sum of approximately $254,450, to which should be added the mortgage held by the Poughkeepsie Savings Bank of approximately $160,000, making a total of about $414,000—still less than the assessed value. Until the debtor's property was actually sold in 1946 no one could say with any certainty just what this property would bring. There was no real market for the property prior to 1946 and no means, therefore, of determining its fair value.

2. **The alleged acquiring of control of the debtor by respondents:** There can be no doubt that none of the respondents was ever in control of or even exercised the slightest influence upon the affairs of the debtor corporation. It has already been pointed out that none of the respondents were officers or directors or ever had anything whatsoever to do with either the operation, management or the sale of the debtor's property. Furthermore, considering the character of the debtor's business and operations, the obtaining of control would be and in fact was completely meaningless. At all times after Norman and

Sanford Becker became directors in April of 1942, the operation of the debtor's apartment house in New Rochelle was handled by the Westchester Trustees, a nonprofit organization representing the various title companies and banks owning property in Westchester County (R. 128-131). This servicing organization had been selected by the then directors of the debtor corporation in April, 1942 (R. 128), before Norman and Sanford Becker had become directors (R. 128). Even after the $15,000 second mortgage loan had been made by the Baset Realty Corporation, the Westchester Trustees continued on as managing agent (R. 129), and when this second mortgage went into default and a rent assignment was executed by the debtor corporation to Baset in October of 1943, the Westchester Trustees continued to operate the property just exactly the same as they had been doing before the placing of the Baset mortgage (R. 130). This managing agent collected and deposited the rents; arranged for all repairs and drew all checks in payment of debtor's bills and obligations. These checks required the signature of Mr. Richard Kelly, the President of the debtor corporation (R. 130). Neither of the Becker brothers nor Fribourg had anything whatsoever to do with the actual management of the property (R. 129). Manifestly, no sale of the property could ever be made unless 66-2/3% of the stockholders (who were the same as the debenture holders) agreed, and at no time did the respondents ever own that percentage of the outstanding bonds. Indeed, when the property was finally sold for $300,000 in 1946 a meeting of the stockholders had to be called to obtain approval of such sale. Moreover, until June 28, 1944, Norman and Sanford Becker were only minority directors, and Richard Kelly and William Henry Hays, both large debenture holders, remained actively in charge of debtor's affairs as President and Vice President. Only when they resigned on June 28, 1944 after disposing of their deben-

tures were the vacancies filled by Sanford Becker's appointees. But by that time all of the bonds owned by respondent Regine Becker had been acquired, with the exception of $2,500 face amount, and a large part of the bonds owned by the other respondents had been similarly acquired. Even after June 28, 1944 there was nothing that the Board of Directors of the debtor corporation could do in furtherance of the alleged control which petitioner charges Norman and Sanford Becker with having acquired. The Westchester Trustees continued to operate the property as before and nothing whatever happened until the $300,000 offer was approved by the stockholders.

3. **Removal of debtor's office in 1942 to Sanford Becker's office**: In April, 1942 the statutory office which the debtor was obligated to maintain was moved to the Treasurer's office at 11 West 42nd Street, New York City, because Mr. Kelly, the debtor's then President, refused any longer to house the debtor in his office and no funds could be spared to rent another outside office (S. M. 344). But this in no way vested control of the debtor corporation or of its property in the Beckers since, as has been explained, there was nothing to control. The two Becker brothers still remained minority directors up to June 28, 1944 and Mr. Kelly continued on as President and Mr. Hays as Vice President (S. M. 74).

As for the suggestion in petitioner's brief that the three respondents through the Becker brothers as directors acquired for themselves secret knowledge concerning the debtor's property which was not accessible to anyone else, it will be sufficient to point out that the respondents Regine and Emily Becker never even saw any of the records or the earning statements or the profit and loss statements of the debtor corporation (S. M. 204). They did see the debtor's building from the outside but that was

the whole extent of their acquaintance with the debtor's status and operations (S. M. 205). As for the respondent Fribourg, he never saw any of the books or records of the debtor corporation (S. M. 127), and never examined any of the figures of the operation (S. M. 128). He did talk from time to time to the Becker brothers and, as was natural, asked them how the affairs of the debtor corporation were progressing (S. M. 128). He had no contact whatever with the managing agents of the property nor with the property itself (R. 113), and he knew nothing whatever concerning inquiries made from time to time by brokers regarding a sale of the property (R. 112; Finding No. 30; R. 73).

4. **Second mortgage loan of $15,000 made by Baset Realty Corporation**: Petitioner refers to this loan as one of the steps by which "the Beckers had effective control of the situation". It is also suggested at page 6 that the identity of the Becker-Fribourg group with Baset was not disclosed. Both of these statements happen to be completely erroneous, but even if they were correct they could have no possible bearing upon the sole question involved in this appeal.

Though petitioner has constantly reiterated that Sanford Becker concealed who were the parties furnishing the money to Baset Realty Corporation, the fact is that there never was such a concealment. The very checks for the $15,000 which Baset advanced on the mortgage were checks of Sanford Becker (R. 99), and the receipt which Mr. Amend, the debtor's counsel, gave for this money acknowledged these two checks of Mr. Becker (R. 99, Obj. Ex. 8; R. 164). Mr. Kelly, the President of the debtor corporation, was told that it was the respondents who were advancing the Baset money (R. 101), and that fact appears not only in the minutes of the stockholders' meetings (S. M. 266) but also in the minutes of the directors

of April 7, 1942 (Obj. Ex. 8; R. 164). In the face of these facts there is no justification for the statement made on page 13 of petitioner's brief that Mr. Amend did not know of the identity of the Becker-Fribourg group with Baset. Referee Olney's Finding No. 54 (R. 77-78), is to the effect that in the acquisition of the debentures by the respondents there was practiced no "overreaching or concealment or failure to disclose to any other debenture holders material facts".

It is difficult to understand why this point as to who put up the money for Baset has been dilated on so greatly in this case. The notion that any of the debenture holders who sold their securities to respondents would not have done so if they knew who put up the money for Baset is so fantastic as to be incomprehensible. Certainly, all of the directors and officers knew the facts. Not the slightest attempt was made to conceal them and there would have been no point in doing so.

This Baset mortgage, in our view, contains the most significant evidence of the absolute good faith and lack of over-reaching practiced by the respondents and also by the much maligned Becker brothers. It is only necessary to read Referee Olney's Finding No. 25 (R. 73) to be satisfied that it was "the assistance rendered to the debtor by the Becker women and Fribourg through Baset" which "materially helped debtor in weathering the grave financial situation through which it struggled". Except for this loan the debtor's property would have been sold in 1941 to the Chesterbrook Estates, Ltd. for $220,000, which amount, as Mr. Kelly, the debtor's then President certified, would have netted the debenture holders no more than 5% on their bonds (Resp. Ex. 22; R. 154).

It is true that when this second mortgage went into default, Baset took a rent assignment, but actually this

effected no change whatsoever in the operation of the property (R. 130). The Westchester Trustees who were then managing the property for the debtor corporation were continued and went on operating the property just as they had before (R. 130). The statement on page 8 of petitioner's brief that by the taking of this rent assignment "the actual physical operations of the property were completely under the control of Baset as mortgagee in possession, functioning through its own managing agent", is completely without basis in fact.

5. **The acquisition of debentures by respondents:** Here again petitioner sees only wrongdoing in perfectly normal transactions. The reason why some of the debentures which appear to have been bought in the Fribourg account carried by Sondheimer & Co. were paid for and are now owned by the respondents Regine and Emily Becker, has been thoroughly explained (S. M. 145-146, 244). These particular securities had been ordered purchased by respondent Fribourg but when they were delivered he was out of town and they were paid for by Sanford Becker. When Fribourg returned he was told what had happened and Fribourg stated that he was then not interested in acquiring any more securities but had no objection to the Becker ladies taking over these securities if they wished. They thereupon did so and paid for the securities with their own funds (S. M. 244-245). Referee Olney could see nothing suspicious or improper in this entirely normal business transaction. Of course, petitioner finds in these purchases from Sondheimer & Co. "a concerted plan to purchase the debentures which now form the basis of the respondents' claims". The wholly untenable character of this inference becomes clear when it is borne in mind that Sanford Becker, when he wanted to purchase any of the debtor's securities, did so openly in his own name. It has already been mentioned that he at all times

has been a holder of a block of $5,000 face amount of these bonds ever since 1941. The notion that Sondheimer, a mere dealer in the over-the-counter market, would not have sold the bonds ordered purchased by the respondent Fribourg if he had known that the Beckers were the buyers is really quite naive. What did Sondheimer, a mere trader, care as to who purchased his bonds so long as that party paid the price he wanted. Moreover, is it not entirely evident that even the people who sold to Sondheimer & Co.—and who, too, for the most part were dealers and traders (S. M. 242)—cared nothing about who the buyers were? Surely, there is no requirement that a broker who has been ordered to buy securities for a customer must reveal the name of that customer to every person who offers the desired security for sale. Even where officers and directors of a corporation wish to buy the securities of their company, no such unreasonable and impractical requirement is imposed. As Judge Swan said in his opinion (R. 182):

> "As to securities purchased from over-the-counter traders, such as the Sondheimer Company and other brokers we should hesitate to lay down the rule that the purchaser from a broker must make disclosure of why he thinks the purchase a desirable investment under penalty of being charged with overreaching if he fails to do so."

At no place has petitioner ever cited any cases supporting its extraordinary contention that the respondents were required to reveal their names not only to all the brokerage firms from whom they bought but also to the customers who sold to such brokerage houses.

What we have said above also applies to the comment in petitioner's brief at pages 8-9 regarding the so-called Winter transactions. Here, however, the petitioner's con-

jectures are even more fantastic than in connection with the Sondheimer purchase. Mr. Kelly, the President of the debtor corporation, by the time May, 1944 had arrived, had gotten thoroughly disgusted and disheartened with the situation existing in the debtor corporation and decided that he wanted to sell his bonds if he could find anyone willing to buy them. It must be remembered that at this time the debtor's fortunes had reached their lowest ebb. Both mortgages on the debtor's property were in arrears and the debtor's property was being operated at a deficit. Moreover, there was a rent assignment outstanding with the possibility that one or the other of the mortgagees might decide to foreclose (See Resp. Exs. 6, 11, 22, 23, 24, 25F, R. 145-164). Mr. Kelly mentioned all this to Sanford Becker (S. M. 135, 301), and the latter in turn told respondent Fribourg about it. This respondent then told Sanford Becker that at a price he would take a gamble on the debtor's debentures (S. M. 136). The respondent Fribourg already owned quite a block of these debentures and as he himself expressed it, he might "just as well gamble" on some more because it did not involve "a tremendous outlay of money" (S. M. 136). He mentioned this subject to his brother-in-law Winter who promptly stated that he would like to go along with Fribourg on the purchase. Mr. Kelly, conscious of his obligations to other debenture holders, stated that he would not accept any offer for his own bonds which was not made equally available to all other bondholders (Resp. Ex. 18, R. 152), and he instructed Sanford Becker to obtain Mr. Winter's offer in writing. Indeed, he himself prepared the Winter offer and the letter to the debenture holders (S. M. 303-307). It was then that Mr. Winter, who before Referee Olney made the ludicrous explanation that he knew nothing about this whole affair, admittedly signed the original offer prepared for him by Mr. Kelly, dated May 2, 1944 (Obj. Ex. 14, R. 63), which Mr. Kelly

in turn sent out to all of the debenture holders accompanied by his letter of explanation as to why he was going to accept Winter's offer for himself (Obj. Ex. 15; R. 64). Mr. Kelly, at that time, was the holder of $8,250 face amount of the bonds and these he sold under the Winter offer. After these bonds had been purchased, Winter changed his mind about going along with Fribourg (S. M. 171). He got into a feud with Fribourg (S. M. 322). Why should the respondent Fribourg buy in Winter's name to conceal his own interest in the bonds? He had already acquired in his own name, prior to the Winter offer, many of the bonds which he now holds, and long after the Winter offer he acquired additional bonds, also in his own name. Certainly, Mr. Kelly did not care whether Winter or Fribourg was the buyer of his bonds. He had made up his mind to sell for reasons deemed by him to be adequate and it is as clear as anything can be that he would have sold to anyone willing to pay the price. Mr. Kelly was an eminent lawyer practicing in New York City for a great many years; counsel and a Trustee for the Broadway Savings Bank; counsel and a Trustee of the Methodist Episcopal Church Home (S. M. 477), and President of the debtor corporation from the time of its beginning in 1933, and it is really absurd to suppose he did not know what he was doing in concluding to sell his own bonds. His written reports and communications show otherwise (Obj. Ex. 15, R. 64; Resp. Exs. 22, 23, 24, 25b, 26e; R. 154-162). With the precarious situation existing in May, 1944, there could be but little doubt that a purchase of the debtor's debentures at that point was nothing more or less than a wild gamble, in which only a speculator—not an investor—would want to engage. It is certainly not a mere coincidence that the other directors and officers all reached the same conclusion and also decided to unload their bonds at whatever price was available.

6. **Claimed lack of disclosure to the public debenture holders:** Petitioner here claims that after control had been obtained by the Becker-Fribourg group and during the time when they were purchasing the debentures, they made no disclosure to the other holders of the debtor's securities of matters which they were under a duty to disclose. This contention was rejected by Referee Olney (See Finding No. 54). In the first place, as has already been pointed out, the respondents never acquired control of the debtor corporation and at no time could they sell the property of the debtor corporation solely on their own decision. In the next place, not only was there no ~~failure~~ to disclose all the relevant information but, on the contrary, there was at all times the fullest disclosure made to the stockholders who were also the debenture holders. A full annual report of the operations of the debtor corporation showing rentals collected and expenses incurred was not only filed each and every year with the Manufacturers Trust Company as Indenture Trustee, but copies of these annual reports were also mailed out to the stockholders every year except the last year when Mr. Kelly, who was still President, declined to personally incur the expense of printing and mailing. The record contains copies of some of these annual reports (Obj. Exs. 27, 29, R. 166-167; Resp. Exs. 3, 25A, 25B, 25E; R. 143, 159, 162). Numerous debenture holders wrote letters from time to time to the President of the debtor corporation asking for information, and in each instance the ~~most~~ full and complete information was given. Samples of such letters are to be found in Respondents' Exhibits 7, 8, 10, 22, 23, 24, 25a, 25b, 25c, 25e, 25f (R. 146-163). There was the fullest discussion concerning the debtor's financial condition at the various board meetings and stockholders meetings, as clearly appears from the minutes. Both the minute books of the stockholders meetings and directors meetings are physical exhibits and can be examined by the Court. They

constitute Respondents' Exhibit 26 and Objector's Exhibit 8—not printed.

Referee Olney endeavored to obtain some definite statement from petitioner's counsel as to just what matters he claimed had been withheld or concealed from the other so-called public debenture holders (See Finding No. 39; R. 75). The only matter then claimed to have been concealed or not disclosed related to the "so-called offers to purchase debtor's property after the Spring of 1942, in an ever increasing amount". Referee Olney has carefully reviewed all the testimony offered by the petitioner and points out explicitly in Findings 40, 41, 42 and 43 that at no time from the Spring of 1942 down to the very end was there a single real offer submitted for the purchase of the debtor's property until the $300,000 offer which was accepted by the stockholders in January, 1946.

Petitioner's contention, referred to in Finding No. 39, that there were so-called offers to purchase debtor's property after the Spring of 1942 in an ever increasing amount, is totally unfounded, and it is surprising that petitioner insists on repeating the same in the face of the record facts to the contrary. From May 1, 1942, the property of the debtor corporation was being managed and operated by the Westchester Trustees (S. M. 438-439). Mr. Jordan of the Westchester Trustees, concededly a wholly disinterested witness, told of his efforts to sell the property (R. 140-141) throughout the years that he was managing it. Although he saw many different brokers during these years and gave them all of the information asked for concerning rentals; dimensions and condition of the property, and although he requested these brokers to submit offers for the property, he never received one single offer (R. 141). So far as the debtor's officers were concerned—aside from the offer of the Chesterbrook Estates of $220,000, which was turned down by the stockholders in 1942—it is the uncontradicted proof that not a single

bona fide or legitimate offer was received for the property until the Fall of 1945 (by which time substantially all of the bonds here in question had been acquired) (S. M. 349). At that time, not an offer, but an inquiry was received from a broker (R. 122). This broker inquired of Norman S. Becker whether the debtor corporation would entertain an offer of $280,000. He was told that the corporation was holding the property for $300,000 (R. 123). Except for this inquiry made in 1945, the only other interest shown in the property by any broker or buyer was an alleged offer of $250,000 received from a broker by the name of Rubin in November of 1944. The offer was supposed to have been made on behalf of one Solomon (R. 122). Although Mr. Becker tried to find out who Solomon was, he could obtain no information whatever about him (R. 122). Nor could he find out much about Rubin, the broker, who had no office (S. M. 373). The offer was not accompanied by any deposit and it was, obviously, a "phoney" proposal designed to lay the groundwork for a claim for brokerage commissions. Actually, that happened, for Rubin brought a suit for brokerage commissions against the debtor and the suit was dismissed by the Court without trial (S. M. 372).

It has been amply demonstrated that there was not the least interest displayed in the property by prospective purchasers from 1942 down to the end of 1945, and that not one real offer had been received for the property until the $300,000 offer came along in 1946. As for the supposed increasing value of the property, it is difficult to understand where petitioner claims to have established any such fact. Surely, the lack of offers and the complete indifference which buyers displayed over the entire period did not establish an increasing value. It is undisputed that the upward price trend in real estate in apartment house property located in Westchester County did not even begin until the latter part

of 1944 (S. M. 450), and that throughout the years 1942, 1943 and 1944 conditions with respect to such property were very bad and the outlook extremely pessimistic (S. M. 469; Resp. Exs. 20, 21—not printed). The property continued to operate at a loss throughout 1942, 1943 and 1944 and earned a small profit for the first time in 1945 (S. M. 446-449). We submit that, in the face of these facts, the officers of the debtor corporation would have been assuming a grave risk to tell the debenture holders that their property was steadily increasing in value, and that there was a steady stream of offers being received therefor. Such statements would have been not only untrue but reckless.

Even the dissenting opinion of Judge Learned Hand concedes the total lack of merit of petitioner's complaint upon this point. Judge Hand said (R. 186-187): "I agree that the trustee's case broke down, so far as it rested upon the suppression of any specific information that the property was going to increase in value * * *."

And Judge Swan, in the prevailing opinion, pointed out (R. 181):

> "During the period when the appellees were purchasing their debentures the debtor was receiving frequent inquiries from brokers as to terms on which its property might be bought, but no 'firm' offer to buy was submitted after the offer rejected by the shareholders in 1942 until receipt of the $300,000 offer which the debtor accepted in January 1946."

The Grounds Upon Which the Decisions of the Courts Below Rested.

Petitioner asserts under this heading that the Referee, the District Court, and the Court of Appeals, although all reaching the conclusion that petitioner's objections

should be overruled, yet disagreed between themselves as to the theory or ground upon which that should be done. This assertion is not correct.

Both Referee Olney and Judge Goddard in the District Court held that even a director of a going corporation could acquire unmatured obligations of his corporation at a discount, although at such time the corporation may have been insolvent, provided the debtor had not set up any special fund to pay the said obligations; that no special liquidation had been ordered through the institution of receivership or kindred proceedings; that the debtor was not in the field to settle its own obligations, and that in acquiring such obligations the directors did not act unfairly to their corporation nor become involved in competition with it; and that the directors were not guilty of overreaching by unfairly using their special knowledge in dealing with those from whom they acquired the obligations. Such holding was supported with the citation of numerous cases—both Federal and New York State (R. 79, 94-95). Judge Goddard in his opinion emphasized that the rule of law applied by Referee Olney was undoubtedly the correct rule under the numerous decisions handed down by the Courts of New York State with respect to securities acquired by directors of a corporation that was "a going concern" (R. 120). There is thus no warrant for petitioner's claim that Judge Goddard's reasoning and conclusions differed from those by Referee Olney. Furthermore, it is again incorrect to say, as petitioner does, that Referee Olney relied principally upon the decision of this Court in *Securities and Exchange Commission* v. *Chenery,* 318 U. S. 80. That case was mentioned by the Referee merely for purposes of comparison but was not utilized as an authority.

In the majority opinion in the Court of Appeals, Judge Swan, just as Judge Goddard had done, declared

that the Federal Bankruptcy Law and not State law governs distribution of a bankrupt's assets to its creditors, citing *Prudence Realization Co. v. Geist,* 316 U. S. 89. Judge Swan, however, then went on to point out that even on the basis of the Federal decisions on this subject, as declared by this Court and other Federal Courts, the conduct of the respondents here complained of was not such that the Bankruptcy Court would have been justified in penalizing them by reducing their claims to the amounts paid therefor.

Thus, it will be seen that there has been no divergence of view between Referee Olney, Judge Goddard and Judge Swan. An examination of the opinions written by each clearly shows that though they considered the matter from various angles, each found the conclusion unavoidable that the respondents were entitled to prove their claims for the face amounts thereof, just as other creditors.

It is, of course, true that in his dissenting opinion in the Court below, Judge Learned Hand disagreed with his colleagues on the one question as to whether, under any circumstances, directors of a corporation who acquire securities of their corporation by purchase from others may, at a later date when the corporation becomes insolvent, prove their claims for the full amounts thereof. Judge Hand, while agreeing with Referee Olney, Judge Goddard, and Judges Swan and Chase "that the trustee's (petitioner's) case broke down so far as it rested upon the suppression of any specific information" or any other form of wrongdoing or inequitable conduct, yet advanced the view that while directors of a going corporation—even an insolvent one—should ~~not~~ be completely prohibited from buying the debt securities of their corporation, they should be permitted to do so only if when they made such purchases they had reasonable grounds for believing

that their corporation had a good chance of effecting a composition and going on with its business. Unless this was proved, it was Judge Hand's notion that the directors so purchasing the securities should not be permitted to make a profit on the purchase. He added, however, that he would not apply this rule to "any bonds bought by a director from a director", because "surely they stand on an equality." He also expressed doubt as to whether this rule should be applied when the purchases are not made by directors but only by members of their families.

At this point it is not necessary to make any comment upon Judge Hand's views, except to point out that, on the basis of his concession to the majority opinion of his Court, all that would remain in controversy in this case would be an utterly insignificant amount representing the profit on the $15,750 face amount bonds that were acquired on the so-called Winter offer, discussed on pages 18 and 19 hereof.

Summary of Argument.

I.

There is no statutory prohibition, Federal or State, against the purchase of debt securities of a going concern by members of directors' families or friends—or even by directors themselves—though the corporation at the time of such purchases may be insolvent in the sense that its total assets are worth less than the amount of its liabilities.

II.

Nor are there any controlling authorities, Federal or State, forbidding such purchases and holding that in the event such purchases are made and bankruptcy later

ensues the claims of the purchasers must be limited to the amounts paid therefor.

III.

Though there are certain well recognized exceptions to the rule expounded in II, none of such exceptions are applicable to the facts involved in the instant case.

IV.

Even if the prohibitions contended for by petitioner do exist in the case of directors, they do not exist in the case of non-fiduciaries, such as the respondents on this appeal who never were directors or officers of the debtor corporation nor ever had any connection with the management or operation of the debtor's business.

V.

No considerations of public policy or equity require such an unjust, artificial and vague doctrine as is contended for by petitioner, and the imposition of such a doctrine by court decision would create an unnecessary disturbance in the common practice of business which would defeat its own purposes.

VI.

In any event, such a limitation proceeding as is here invoked by petitioner is not countenanced in a proceeding for arrangement under Chapter XI, nor does anything in that Chapter permit the filing by creditors of an application to limit the claims of other creditors.

VII.

The lower courts correctly decided the issues here presented and the order appealed from should therefore be affirmed.

Argument.

POINT I.

The fact that the respondents, Regine Becker and Emily Becker were the mother and wife of one of the directors of the debtor corporation and that the respondent Fribourg was a friend and office associate of the said Becker did not place them in the position of directors or fiduciaries and deprive them of their right to prove their claims for the full face amount of the bonds held by them.

We deal with this subject first because if this Court should affirm the rulings in the courts below, differentiating between purchases of securities made by directors and those made by members of the families and friends of directors, with their own funds and for their own account, it will become unnecessary to consider the issue as to what, if any, prohibitions exist against directors themselves.

In its brief, petitioner has blandly assumed that as a matter of law respondents were in the same position as directors. Though Referee Olney sustained this point of view with respect to the respondents Regine and Emily Becker, and Judge Goddard held that the respondent Fribourg should also be treated as though he were a director, the majority opinion in the Court of Appeals rejects this view of the case (R. 185-186). And even Judge Learned Hand, in his dissenting opinion, expressed some doubt about this rule so far as it applied to the respondent Fribourg (R. 188). As Judge Swan pointed out in his opinion, this question of law is one upon which the conclusions of the Referee and District Judge are not controlling on appeal (R. 185).

As we have already shown at pages 4 and 5 of this brief, the record shows, without dispute, that not only

were the three respondents never officers or directors of the debtor corporation, but that the purchases of the debenture bonds which they made from time to time were, in every instance, made with their own funds.' Norman and Sanford Becker, the directors, neither participated in nor have any interest whatsoever in the respondents' purchases. None of the respondents had anything whatever to do with the management or operation of the debtor's business or with the negotiations for the sale of its property (S. M. 127, 157-158, 181-182). These respondents never even saw the books or records of the debtor corporation. Nor did they have any business relations with the two directors (S. M. 97-98). The respondent Fribourg maintained desk room in the suite of Sanford Becker and the latter acted as accountant and nominal secretary of a certain corporation known as Windsor Buildings, Inc., of which Fribourg was president (R. 170). Becker, however, had no financial interest whatever in this corporation.

Assuming for the moment that there is, as maintained by petitioner, a rule forbidding directors of a corporation from purchasing its debt securities while the corporation is insolvent, the question immediately arises why such disability should extend to persons who are not directors or fiduciaries merely because these persons happen to be related to or friendly with the directors. Judge Swan held that where third parties, such as the respondents, are guilty of no overreaching or wrongdoing there is no reason to impose administrative sanctions on them so as to deprive them of any profit which they have earned by reason of their purchases. He said on this point (R. 185-186):

> "The appellees were not directors or officers of the debtor; their own funds were invested, and no officer or director of the debtor has any

interest in the debentures they purchased. In the case of *In re Philadelphia & Western Ry. Co.*, 64 F. Supp. 738, 741 (E. D. Pa.) the court declined to limit the claim of J. Prescott Stoughton who was the father of an officer of the debtor corporation. In so ruling he stressed the fact that the father was not a fiduciary who owed a duty to the debtor, that the purchases were made by the father with his own funds and for his sole account, and that neither the son nor any other person associated with the debtor had any interest in his dealings in the bonds of the debtor. For similar reasons he declined to limit the claim of Agnes C. McKernan who was an officer of the Conway Corporation which had a management contract with the debtor for the management of the debtor's business. These two claims present a closer analogy to the purchases at bar than do any of the other cases brought to our attention. It is true that one who 'knowingly confederates' with a fiduciary in a breach of trust is not allowed to make a profit from the transaction. *Jackson* v. *Smith*, 254 U. S. 586, 589. But 'knowingly confederating' means more, in our opinion, than investing one's own funds on a 'tip' received from an officer or director of a debtor. With respect to Fribourg we see nothing in the record to justify a finding that he did more than this. As respects the Becker ladies, since they exercised no independent judgment in the investment of their funds, they are chargeable with the knowledge of their agent, Sanford Becker. But since there was no overreaching of the sellers when he made the purchases for his wife and mother, we do not think the disciplinary sanction for 'knowingly confederating' with a disloyal fiduciary should be imposed."

Judge Learned Hand, in his dissenting opinion, while agreeing that the Becker ladies should stand in the same position as directors, yet expressed doubt as to what the correct answer should be in the case of the respondent Fribourg (R. 188). However, since he took the position that even directors have the right to purchase debt securities of their corporation during insolvency if they entertain the genuine expectation that the business will continue, he naturally rejected the extreme view pressed by petitioner that the mere existence of a state of bankruptcy insolvency forbids not only directors but also their relatives or friends from reaping a profit on any purchases of debt securities made during such insolvency.

Judge Swan stated that he found support for the position which he and Judge Chase took in the decision of Judge Kirkpatrick in the case of *In re Philadelphia & Western Ry. Co.,* 64 F. Supp. 738, 741 (E. D. Pa.), and also another decision written by the same Judge in the case of *In re Real Estate Mortgage Guaranty Co.,* 55 F. Supp. 749, 752 (R. 184-185). There can be but little, if any, doubt that the viewpoint expressed by Judge Swan and by Judge Kirkpatrick on the point here under discussion is sound in principle and well fortified by authority. (*Anderson* v. *Blood,* 152 N. Y. 285; *Okin* v. *Securities and Exchange Commission,* 137 Fed. [2d] 398; *In re Lorraine Castle Apartments Bldg. Corp.,* 149 Fed. [2] 55 [C. C. A. 7-1945]; certiorari denied 326 U. S. p. 728; *In re Franklin Building Co.,* 83 Fed. Supp. 263 [D. C. E. D. Wis. 1948].) In the *Matter of Wade Park Manor Corp., Debtor* (D. C. Northern District of Ohio, Eastern Division) decision of Hon. C. D. Friebolin, Special Master, dated July 28, 1949, not reported.

In the *Franklin Building Co.* case, *supra,* the precise question here involved was adjudicated, although in that

case the proceeding in the District Court was one filed under Chapter X. The Trustee argued, as does the petitioner here, that certain members of the families of directors who had purchased securities with their own funds could not prove their claims for more than the amounts paid, because they were affected by the same fiduciary duties and obligations as were the directors themselves. Judge Duffy, overruling this contention said (p. 267):

> "We must next consider whether the disabling rule hereinbefore stated should be extended to members of the family of William A. Schroeder and to Elizabeth Richter, whose husband, A. W. Richter, was an officer and director of the Franklin Building Company. I think the situation as to Mollie Schroeder, June Kuptz, and Elizabeth Richter (to the extent of $5,000) is clear. They were not in a fiduciary relationship. Their bonds were purchased with their own funds; there is no intimation in the evidence that such purchases were made as the agents of William A. Schroeder or A. W. Richter, respectively, or as a device or subterfuge to cover purchases by them. The Court of Appeals for the Seventh Circuit, in *Re Lorraine Castle Apartments Bldg. Corporation, Inc.*, 149 F. 2d 55, 57, held that Section 212 of the Bankruptcy Act does not apply to third parties, or to those who are under no fiduciary obligation. * * *"

In the *Lorraine Castle* case, *supra,* the Court of Appeals for the Seventh Circuit, while not approving the ethics reflected in the purchase by the claimants (who were not directors) of the bonds there involved yet held that there was no fraud established and that these claimants "owed no fiduciary duty to the estate or its beneficiaries", and stood in a position of "speculators in

securities who thought the bonds were selling too cheaply and that they might make a legitimate profit upon them."

The case of *Anderson* v. *Blood*, 152 N. Y. 285 (1897) enunciates, it seems to us the correct rule which should be applied in a situation such as that here under consideration. That case held that before parties acting with a fiduciary can be penalized for any violation of duty on the part of the latter, they must be shown to have had actual knowledge that what they were doing constituted a violation of the fiduciary's obligations. In that very case the Court was asked to rule that at the least the defendants owed the duty of making an inquiry. Rejecting that argument, the Court, through Judge Gray, said (p. 295):

> "The question is not whether Mrs. Blood *could* have discovered the existence of any fraud by an inquiry; but it is whether, acting as an ordinarily prudent person would have done, she was called upon, under the circumstances, to make inquiry. Were the circumstances such as to necessitate the making of some inquiry, at the peril of being charged with the knowledge of some then unperceived fact?"

If the doctrine dealing with the violation of fiduciary duty by directors is to be extended to third persons who owe no such fiduciary duty, then certainly such extension must rest upon the commission of some wrongdoing by these third persons. Can it be said that the purchase of securities in an open market for the account of such third persons, in which the directors do not share or benefit in any way, is wrong? Who can be wronged in such a transaction? Clearly, not the people who freely sell in the open market and who are in no way defrauded by false representations made to them or by having material facts

concealed from them. Is the corporation wronged? Obviously not, since, as pointed out in the case of *Seymour* v. *Spring Forest Cemetery Assn.*, 144 N. Y. 333, it will cost the corporation which issued the securities no more whether such securities are held by strangers or friends or families of the directors or directors themselves.

In the case of *Okin* v. *Securities and Exchange Commission*, 137 Fed. (2d) 398, 1943, Judge Clark, speaking for the Court of Appeals for the Second Circuit, pointed out at page 401 that officers and directors of a corporation may purchase securities of their own corporation from investment bankers and even directly from their company, and that this constitutes no fraud on other security holders. He went on to say that *a fortiori* there is nothing to prevent a sale to a friend.

The rule enunciated by the cases just considered is one grounded in common sense and in the realities of every day life. There is nothing inherently wrong or objectionable in officers or directors of a corporation making recommendations of purchase to other people, and no sound rule of policy requires that such transaction be regarded as tainted because the corporate issuer of such securities might then be in a technical sense insolvent or might, years later, resort to bankruptcy or reorganization.

Were this a situation where the respondents aided the directors as fiduciaries to commit some breach of their duty for the enrichment or profit of the fiduciaries, as in *Jackson* v. *Smith*, 254 U. S. 586, there might be some basis for petitioner's argument. But no such situation exists in this case. The directors did not and could not profit from their advice. One of the directors, Norman Becker, never owned any securities, and testified that he did not care to buy any (S. M. 385). The other director, Sanford Becker, had already bought $5,000 of the debtor's debentures in 1941 and he evidently could not or did not care to add to this personal holding. He, however, believed in the enterprise and seemed confident that the

property—if it could be carried through the war period—would finally enhance in value. He was willing, on the basis of his confidence, to have his mother and wife risk their moneys in the debtor's debentures. Whether the debtor was solvent or insolvent, what was there wrong about that and who could possibly be harmed? If these respondents had not bought these securities, other dealers or traders in the bonds would doubtless have done so. In the end, the result would have been exactly the same.

Under Section 16(b) of the Securities and Exchange Act of 1934, directors of corporations are forbidden from making any short term profits on any securities of their own companies which they may buy and re-sell within a period of six months. If the rule contended for by the petitioner were correct, there would be no logical answer to the proposition that when such directors recommend the purchase of securities of their own corporations to members of their family or friends, these parties, too, should be required to pay over to the corporation any short term profits made by them. But there is manifestly no such doctrine in existence.

The strange result which approval of petitioner's contention would produce is that the profit realized by respondents from the risk which they assumed would be passed on to the other remaining debenture holders—not to the people who sold out. Many of these beneficiaries are themselves speculators who bought their bonds at the very time and under the same conditions as respondents.

The whole philosophy of petitioner's argument that the rule against fiduciaries should be extended to third persons who are members of families or friends of directors, necessarily rests on the assumption that a wrong is committed against the whole body of security holders of a corporation if directors are permitted to give advice to close friends or relatives to buy the securities of such corporation; that such third persons are bound to make a profit by following this advice and that this must, under

all circumstances, be forbidden in the interest of the public welfare, since it would inevitably lead to the creation of a potential conflict of interest on the part of the directors. It is, it seems to us, a sufficient answer to the fallacy underlying that philosophy to point out that as yet neither Congress nor any State legislature has sensed the danger discerned by petitioner and enacted legislation to prevent all acquisition of debt securities of an insolvent corporation by directors—much less close friends and relatives of the directors. On the contrary, the right of third persons and indeed of directors themselves to freely buy and sell such corporate securities has long been recognized. (*Seymour* v. *Spring Forest Cemetery Assn.*, 144 N. Y. 333; *Hauben* v. *Morris*, 255 App. Div. (N. Y.) 35; *Glenwood Mfg. Co.* v. *Syme*, 109 Wis. 355; *Ripperger* v. *Allyn, et al.*, 25 Fed. Supp. 554 [S. D. N. Y.].) We shall have occasion to discuss these cases and others quite fully in the following point of this brief. We mention them now only to indicate that, absent fraud, overreaching or inequitable conduct, there has never been any restriction imposed by statute or even by judicial authority on the right of close friends and relatives of directors of going corporations to freely buy and sell the debt securities or capital stock of such corporations. The notion that such purchases by third parties always results in a profit is, of course, thoroughly naive. Common experience demonstrates how often losses are taken in the securities market on purchases made as result of advice and tips of directors and so-called insiders.

It seems to us manifest that nothing could be more desirable from the standpoint of the security holders of any corporation than to have a ready market available in which they can sell their securities whenever they feel obliged to do so. The more buyers there are in such a market, the better for the sellers. Certainly, in the case of securities of a corporation selling at very depressed levels which reflect the condition of the corporate business,

t is particularly desirable that those security holders who cannot afford to take the risk of retaining their ecurities should be in a position to sell. If members of amilies and friends of directors are willing to take the isks involved in buying such securities, they should be ermitted to do so and no penalty should be imposed on hem which is not imposed on strangers who, under the ame conditions, make similar purchases. As Judge Lindey pointed out in his decision in the *Lorraine Castle* case, *upra*, page 58:

> "To reduce the participation to the amount paid for securities, in the absence of exceptional circumstances which are not present here, would reduce the value of such bonds to those who have them and want to sell them. This would result in unearned, undeserved profit for the debtor, destroy or impair the sales value of securities by abolishing the profit motive, which inspires purchasers."

Significant it is that both petitioner and the Securities nd Exchange Commission have failed to cite a single ase where, on similar facts to those here existing, the ourts have entertained the limitation proceeding against hird persons. As we shall show in the next point where e discuss the right of directors themselves to purchase lebt securities of their corporation, all the cases cited by etitioner and the Commission where the claims of third ersons have been limited to the amounts paid will be ound to fall under well recognized exceptions to the rule which we are here discussing. In all of these cases it will e found that the purchases were made (1) while reorganization proceedings were pending, (2) in contemplation hereof, or (3) where there was express violation of fiduiary duty if not actual fraud.

POINT II.

(a) Even if the respondents had been directors or fiduciaries of the debtor corporation, they would have had the right to make the purchases of debtor's securities here involved.

(b) The Insolvency Restriction Doctrine, even if it exists, could not and should not be applied in this case.

As we mentioned in Point I, if the Court adopts the distinction between purchases made by directors and those made by members of the families and friends of directors, which has been approved in the lower courts, it will be unnecessary to consider the argument which we make in this Point II.

Assuming, however, that this Court does not accept the distinction above referred to and considers that the respondents stood in the same position as directors, then we propose to show that even the directors of the debtor corporation would have had the right to purchase the securities here involved without standing in peril of a limitation proceeding.

At the outset, it will be useful to bear in mind that even petitioner concedes the right of directors to freely buy and sell debt securities of their corporation while such corporation remains solvent. The contention of the petitioner is that when insolvency occurs directors lose the right to make such purchases and that if they insist on doing so, they will have their claims limited to the amounts paid.

The impossibility of applying the insolvency restriction doctrine here.

The insolvency in the instant case on which petitioner relies for the application of the limitation doctrine arises out of the fact that when the debtor's property was sold in 1946 for $300,000, that amount was insufficient to pay all

of the debts of the debtor corporation. From this, petitioner assumes that the debtor's property was never worth any more than $300,000 during the five-year span between 1941 and 1946 when the bonds here involved were acquired by respondents. Petitioner called no appraiser or other expert witness to testify to the value of debtor's property at any period. It merely relied on the final sales price obtained in 1946. We respectfully submit that this is wholly insufficient to establish insolvency on the material dates here involved, viz. the date of acquisition of the securities (*Acme Food Co.* v. *Meier*, 153 Fed. 74 [C. C. A. 6, 1907] at p. 77; *Burns Bros.* v. *Cook Coal Co.*, 46 Fed. [2d] 31 [C. C. A. 3, 1931] at p. 32). As was said in the *Acme Food* case:

> "If the act of bankruptcy be the giving of a preference under subdivision 2, or the permitting of a preference through a legal proceeding under subdivision 3 of the same section, there must be a state of insolvency at the time of the preference and solvency or insolvency at the time of the filing of the petition can only have a reflex importance, if any."

If the price realized on the sale of the property in 1946 has any cogency in the determination of the value in the preceding five years, much more cogency attaches to the fact that the City of New Rochelle assessed the debtor's property throughout all that period at $421,000—an amount which establishes complete solvency.

Petitioner obviously recognizes the infirmities in its claim of bankruptcy insolvency and so it also contends at page 19 of its brief that the debtor was likewise insolvent in the equity sense. The support relied upon for this last contention is Finding No. 12 made by Referee Olney (R. 71) and Respondents' Exhibit 17 (R. 68). To be sure, the debtor corporation was in a precarious condition during the years 1942-1944, more or less continually oper-

ating at a loss but, as we pointed out at page 10 of this brief, it did manage to hold on to its property and avoid closing down and finally paid all of its current creditors 100 cents on the dollar. Throughout the period beginning with the debtor's organization in 1933 and ending with the sale of the property in 1946, the debtor corporation incurred debts aggregating perhaps $600,000 or more. Every penny of this it paid in full. If it fell behind one month it made this up in the following month or months. No one who extended any credit to the debtor corporation lost one penny. The only people who took any loss were the bondholders of the predecessor corporation who on the reorganization in 1933 accepted the income debenture bonds issued by the debtor corporation. It is these original bondholders of the prior company and only they who took a loss. Thus the most that can be said about the debtor's supposed equity insolvency is that such debtor occasionally became unable to meet its current obligations as they matured but it met them at a later date. That such a situation as we have described would justify a finding of equity insolvency is most doubtful. Referee Olney refused to make any such finding. All he found (F. 55, R. 78), is that when the purchases here under consideration were made "debtor was insolvent in that the aggregate of its property was not at a fair valuation sufficient in amount to pay its debts," * * * This finding he, of course, based on the terminal result in 1946 when the property was finally sold for $300,000, since there was no other testimony presented.

The first question to consider is whether, assuming the correctness of the petitioner's contention that insolvency (undefined) should cut off the right therefore enjoyed by directors to freely purchase the debt securities of their corporation, such a vague, indefinite and impractical rule can possibly be applied or enforced in a case such as the present. In the *Wade Park Manor Corp.* case, decided by Special Master Friebolin, to which we have

heretofore referred, the situation with respect to insolvency was almost identical with that in the instant case. The learned Special Master made the following observations on the utter impossibility of applyin gand enforcing any such proposed rule as that here under discussion:

> "The difficulty of applying the rule contended for, is manifest in a case such as this where the purchases covered a period of years long antedating the reorganization proceeding; and where, possibly, in the meantime the debtor might have become solvent (in the bankruptcy sense) for a short period before again becoming insolvent (in the bankruptcy sense). How can one tell what, at a particular time, the real value of property, such as the lease herein, is? Would any court hold a director liable as a *strict trustee regardless of* good faith, if he purchased bonds of his corporation five or ten years ago when the corporation's liabilities —some unmatured—exceeded its assets, then later, the assets equalled or exceeded the liabilities before it again became insolvent? I think not. A director would never be safe in purchasing claims. There would, it seems to me, have to be a showing of more than mere bankruptcy insolvency of a corporation to impose upon a fiduciary, such as a director, a duty of refraining under all circumstances from purchasing claims against the corporation.
>
> It occurs to me, too, that the rule contended for would create quite a disturbance in the common practice of business."

We have already adverted to the interesting fact that in the instant case there was never a time when on the petitioner's theory the directors of the debtor corporation could have purchased its securities, though the debtor

corporation remained in business for 13 years. If the debtor was insolvent in the five-year period preceding the petition for arrangement in the District Court, it was equally insolvent in the eight years prior thereto. Thus, on the strange reasoning of the petitioner, no one but total strangers or outside speculators would have had the right to buy the debtor's debentures at any time. This, it seems to us, is such an unreasonable position that it refutes itself. It seems even more unreasonable when it is borne in mind that no one could know during the years from 1933 down to 1946 what the debtor's property would ultimately bring and whether the appraised value thereof fixed by the City of New Rochelle might in time be realized—if the property could be held long enough. The record abundantly establishes that there was no ready market for this property prior to 1946. It had been offered for sale by Mr. Jordan of the Westchester Trustees (R. 140-142) and it had been offered for sale by the corporation's directors, but no offer was forthcoming. That, of course, did not mean that the property had no intrinsic value or even that it was not worth the full amount of the assessment fixed by the City of New Rochelle. It only meant that there was no ready market for the property. Doubtless, if the appraisers employed by the City of New Rochelle had been called as witnesses, they would have testified that their assessment figure of $421,000 was fair and that in due course of time that price could be obtained for the property. It is an undisputed fact that though the property could not be sold at any price prior to 1946 the property was getting better and finally did begin to enhance in value as a result of the inflation which set in after the end of the War.

How, under the circumstances reviewed, were the directors of the debtor corporation to judge whether they could with safety purchase the securities of the debtor corporation at any time during the 13 years of its ex-

istence, and—much more—how could the respondents make such determination?

The fundamental difficulty with petitioner's contention is that it ignores the realities and the practicalities of the situation, and it erroneously assumes that the insolvency of such a corporation as the debtor corporation, owning but one parcel of real estate, is clearly signalled by some event whose import none can mistake. Moreover, this contention of the petitioner fails to meet the requirement that there must be some definitely ascertainable standard of guilt before one can be penalized for violating a statute or regulation (*Winters* v. *New York*, 333 U. S. 507, at pp. 509, 510; *Connally* v. *General Const. Co.*, 269 U. S. 385; see also 83 L. Ed., pp. 893-921). As was said in the *Connally* case, "a statute which either forbids or requires the doing of an act in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application, violates the first essential of due process of law." Obviously the rule here asserted by petitioner falls squarely within the condemnation of that decision.

Once a corporation applies for bankruptcy or reorganization, no officers or directors or others standing in a fiduciary relationship to the corporation may then traffic in its securities (R. 183-184). That constitutes one of the well recognized exceptions to the rule which we are here discussing. But the filing of a petition for bankruptcy or reorganization is a definite, overt act which all may know about. It is one thing to say that after such a definite, overt act fiduciaries should not be permitted to traffic in the insolvent corporation's securities, but it is an entirely different matter to argue that while there is no bankruptcy or reorganization and while the corporation is pursuing its normal business—albeit with difficulties—directors before daring to buy the corporation's securities, when they regard these as unduly depressed, must obtain an appraisal and then run the risk that even this appraisal may later turn out to have been erroneous.

Another insurmountable difficulty arising out of the vagueness and indefiniteness of the rule contended for by petitioner is that it would even throw into question securities purchased by directors of a corporation during a temporary period of insolvency, later followed by solvency. How are such purchases to be treated? Logically, of course, they would have to be condemned under the petitioner's rule because, having been made while the corporation was insolvent, there could be no defense of any kind asserted in support of such purchases,—either good faith, confidence in the future of the property or anything else. Yet, as Special Master Friebolin pointed out, it is exceedingly unlikely that any court would hold a director to account for purchases so made if the issuing corporation finally achieves solvency.

Anyone making a calm and fair analysis of the complex elements that are involved in the question here under discussion would surely have to agree that it is far more important that directors be permitted to purchase securities of a corporation that might be temporarily insolvent but which they hope they can restore to full health that they be permitted to purchase only securities of a corporation whose solvency cannot be questioned. In the latter group of cases it is not at all likely that the securities would sell at very depressed levels. After all, debt securities of solvent, prosperous companies do not ordinarily sell at substantial discounts. It is only in the case of corporations of questionable solvency and with poor earning records where their debt securities sell down to inordinately low levels. It would certainly seem reasonable that directors who have the courage and vision to believe that they can restore these corporations to financial health and are willing to back up their judgment with their own money by buying the debt securities of such corporations should be encouraged to do so—absent, of course, wrongdoing or inequitable conduct, for

which the courts always have the power to impose necessary sanctions.

We respectfully submit that the very vagueness of the rule contended for by petitioner and the difficulty of applying it are sufficient to compel rejection of any such rule.

Under the Decisions of the Courts of the State of New York, Directors of a Corporation Have Never Been Forbidden From Purchasing the Debt Securities of Such Corporations—Even During a Period of Insolvency.

The purchases here in question were all made in New York State. While the petitioner seems to suppose that this is immaterial and that only so-called Federal law or doctrines govern, we believe that there is ample authority for the contention that the New York law on this subject cannot and should not be ignored, but on the contrary should be given effect.

The leading New York case on this subject and one that is frequently cited in Federal and State decisions is *Seymour* v. *Spring Forest Cemetery Assn., et al.*, 144 N. Y. 333, referred to in the opinion of Referee Olney (R. 79), and in the opinion of Judge Goddard (R. 94). In that case, the Court of Appeals of the State of New York, speaking through Judge Finch, said in an unanimous opinion, at pages 342-343:

> "But the further claim is made that, because Hotchkiss and Seymour were officers of the corporation, holding a fiduciary relation as trustees or directors, they could not lawfully buy the valid and outstanding obligations of the company at less than par and enforce them for the full amount against the debtors. If that be sound doctrine, as is stoutly maintained, if directors cannot in any case invest in

> the bonds of their own companies except at the peril of a constructive fraud, if they cannot safely buy such bonds below par, because they deem them unduly depressed, if titles to corporate obligations passing through their hands become tainted by their touch, it is quite time that the courts should give, what they have not given, a very definite and distinct warning."

Judge Finch then goes on to point out that there are certain exceptions to the rule, (1) that a director cannot buy debt securities at a discount if it was his duty to do so for his principal or, in other words, where the corporation was itself in the market to buy its own securities; and (2) where a director "makes a contract in behalf of his principal with himself directly or indirectly as the other party to the agreement".

Judge Finch then proceeds to point out that in the case before him the two directors neither "bought in any property of the company nor dealt with the corporation in any respect" and that "they made their contract, not with it, but with third persons capable of protecting their own rights, and bought nothing which the corporation owned or to which it had a right." Judge Finch emphasized that the entire basis for the exceptions referred to rests on the "collision between trust duty and personal interest" and that "the equitable prohibition has no application where there is no such possible inconsistency." He then states at page 344:

> "Unless some special fund has been provided, or some special liquidation has been ordered, the director owes no duty to his company to discharge or buy in the outstanding bonds, and may purchase for himself because no inconsistent trust duty has arisen. Why should he not? While the bonds are running to their maturity, and the corporation is

not able to extinguish them, is not bound to do so, does not even wish or seek to do so, what does it matter who holds the securities or on what terms they pass from hand to hand? It seems to me that we are asked to crowd the rule almost to the verge of an absurdity, and to inflict a vital injury upon business interests by tainting with invalidity the holding by a director of the unmatured obligations of the corporation bought by him in the open market and not put in liquidation or sought to be extinguished. There must at least be some fact or circumstance which charges the trustee with a present duty to act for his company in respect to the bonds, which duty is or may be inconsistent with a personal purchase. No such duty rested upon Hotchkiss and Seymour, and they had a right to buy and hold for their own benefit."

And in the much more recent case of *Claude Neon Lights, Inc.* v. *Federal Electric Company, Inc.*, 250 App. Div. 510, the Appellate Division for the First Department, in a decision written by the late Presiding Justice Martin, not only followed the doctrine of the *Seymour* case but approved it (see pp. 517-518). He pointed out in that case that the Federal Electric Company, whose securities constituted the subject matter of the litigation, was not in the market to buy the portfolio of stocks which were later acquired by the defendant directors, and that, therefore, such directors were not competing with their own corporation when they went out and acquired these securities. Mr. Justice Martin very tersely summed up the correct rule applying in these situations when he said:

> "In the absence of proof that the director acted in opposition to or in competition with his corporation, the contract for the sale of the securities may not be upset."

In the case of *Hauben* v. *Morris*, 255 App. Div. 35, the Appellate Division for the First Department again reaffirmed the same rule. In an exhaustive opinion by Mr. Justice Untermyer, the Court said:

> "Likewise, a director may ordinarily buy at a discount the unmatured obligation of his corporation with the intention of collecting in full when the obligation matures. (*Seymour* v. *Spring Forest Cemetery Assn.*, 144 N. Y. 333; *Glenwood Mfg. Co.* v. *Syme*, 109 Wis. 355; 85 N. W. 432; *McIntyre* v. *Ajax Mining Co.*, 28 Utah, 162; 77 P. 613.)"

This ruling of the New York Courts has been consistently applied by the Federal Courts in New York.

In the case of *Ripperger* v. *Allyn, et al.*, 25 Fed. Supp. 554, former Judge Patterson, then sitting in the Southern District Court, passing on a motion to dismiss a complaint in a suit for an accounting, said:

> "Directors and those who occupy a similar relation to a corporation may buy up claims held by strangers against it or may purchase from others liens on corporate property without accountability for profits, when the transaction is fair to the corporation and involves no competition with it."

See, too, *In Re McCrory Stores Corporation*, 12 Fed. Supp. 267 (S. D. N. Y.), also decided by Judge Patterson.

Though as Judge Goddard pointed out in his opinion in the instant case (R. 94)

> "federal bankruptcy law, not state law, governs the distribution of a bankrupt's assets to its creditors * * *"

he also pointed out (R. 94) that

> "the validity of a claim, in the absence of overruling federal law, is determined with reference to state law."

In the decision of this Court in *Vanston Bondholders Protective Committee* v. *Green*, 329 U. S. 156, cited by Judge Goddard, Mr. Justice Frankfurter in his concurring opinion went on to emphasize that the laws of the 48 States governing commercial transactions cannot be, and are not to be, wiped out when a corporation is adjudicated a bankrupt. He added that Congress never intended any such result, saying:

> "To establish uniform laws of bankruptcy does not mean wiping out the differences among the forty-eight States in their laws governing commercial transactions. The Constitution did not intend that transactions that have different legal consequences because they took place in different States shall come out with the same result because they passed through a bankruptcy court. In the absence of bankruptcy such differences are the familiar results of a federal system having forty-eight diverse codes of local law. These differences inherent in our federal scheme the day before a bankruptcy are not wiped out or transmuted the day after."

Petitioner's answers to the argument which we have just made is that (1) even if the New York decisions do support the ruling of the lower courts in the instant case, such decisions would not govern because under the cases of *Prudence Realization Corp.* v. *Geist*, 316 U. S. 89; *American Surety Co.* v. *Sampsell*, 327 U. S. 269; *Heiser* v. *Woodruff*, 327 U. S. 726, and the *Vanston* case, *supra*, "federal law controls the distribution to creditors in bank-

ruptcy," and (2) that in any event the formidable array of New York State and Federal authorities which we have cited do not apply because "in none of these cases did it appear that the corporation was insolvent".

Petitioner's contentions just discussed are incorrect. The *McCrory* case, *supra*, decided by Judge Patterson did involve an insolvent corporation and Judge Patterson drew no distinction in his opinion between purchases of securities of an insolvent corporation as contrasted with those of a solvent corporation. On the contrary, he cited as an authority for his view that "under ordinary conditions a director may purchase claims against his corporation at a discount and enforce them for their full amount; the decision in *Seymour* v. *Spring Forest Cemetery Association*, *supra*, and the decision in *Glenwood Mfg. Co.* v. *Syme*, 109 Wis. 355, which was decided by the Supreme Court of Wisconsin and which dealt with purchases of securities made by a president and director of an insolvent corporation.*

The only case that petitioner has been able to discover which it believes supports its view that the New York courts distinguish between solvent and insolvent corporations, in the situation here under discussion, is *Bulkley, et al.* v. *Whitcomb*, 121 N. Y. 107 (1890). That case, however, is completely inapplicable. It dealt with an attempt on the part of a stockholder against whom judgment had been recovered by a creditor of the corporation under a statute of the State of New York, rendering stockholders liable to creditors for debts contracted before the capital stock called for by the certificate of incorporation is paid in, to offset against such judgment a claim against the corporation acquired by him without any consideration whatever. The gist of the Court's opinion is to be found in the following excerpt appearing at page 112:

*This decision, it should be added contains very cogent reasoning which totally demolishes the artificial doctrine sought to be here imposed by the petitioner.

"The stockholder's liability is a trust fund, which the directors are bound to apply honestly and in good faith for the interest of the company and its creditors, and the officers cannot be allowed to avail themselves of their position and opportunity to deplete that fund for their own benefit, so as to escape the supervision of equity."

The notion that this *Bulkley* case expounds a rule of law different from *Seymour* v. *Spring Forest Cemetery Association*, *supra*, is completely fallacious. Both opinions were written by the same Judge. The *Seymour* case was decided long after the *Bulkley* case. It is obvious that if the rule of law, which petitioner seems to think the *Bulkley* case enunciates, dealt with purchases of debt securities by officers or directors of an insolvent corporation, the decision in the *Seymour* case would have been to the contrary of what it was. But the Bulkley decision was not even mentioned by Judge Finch in his opinion in the *Seymour* case, thus clearly demonstrating that the two cases deal with altogether different facts and involve different principles of law.

It is significant and a complete answer to petitioner's notion that all of the New York cases cited by us deal only with solvent corporations that nothing was said either in the *Seymour* case or in any of the other New York cases to so much as suggest that the rule expounded in these cases does not apply to insolvent corporations.

That there is no basis for the claimed distinction is clear from the two decisions of former Judge Patterson in the *Ripperger* and *McCrory* cases, *supra*, to which we have just referred. While the element of insolvency was not present in the first named case, it is important to note that Judge Patterson in discussing the general rule drew no distinction between purchases of securities of an insolvent corporation as contrasted with those of a solvent corporation. The second named case, however, dealt with

an insolvent corporation and, although there the purchaser of landlords' claims was limited to the amounts paid, under the scrutiny clause of §77-B (11 U. S. C. A. §207[b]), because of the violation on his part of fiduciary obligations, Judge Patterson cited as authority for his view that "under ordinary conditions, a director may purchase claims against his corporation at a discount and enforce them for their full amount", the decision in *Seymour v. Spring Forest Cemetery Association, supra,* as well as the case of *Glenwood Manufacturing Co. v. Syme, supra,* again without distinguishing between solvent and insolvent debtors.

Is it not extremely improbable that the various New York courts, which have spoken on this subject, would not have mentioned the distinction between solvent and insolvent corporations if this made any difference in the rule expounded by them?

Nor did Referee Olney, Judge Goddard or Judge Swan find any basis for the distinction between solvent and insolvent corporations which petitioner proposes. The fullest discussion of this subject is to be found in Judge Swan's opinion (R. 183). He there points out that:

> "It is not immediately apparent why insolvency should make a difference. It will cost the debtor no more whether the dividend which it may be able to pay creditors goes to the original holder of the debt or to a director-assignee."

There Being No Overruling Federal Law Here, the Questions Here Presented Are to Be Determined by Reference to New York State Law Which Clearly Sanctions the Transactions Here Involved.

We have already pointed out at page 49 of this brief that Mr. Justice Frankfurter, in his concurring opinion in the *Vanston* case, *supra,* went on to emphasize that the laws of the forty-eight states governing commer-

al transactions cannot be and are not to be wiped out hen a corporation is adjudicated a bankrupt and that ongress never intended any such result.

Since there is no overruling Federal law proscribing he transactions approved by the lower courts, the rule revailing in the State of New York, enunciated in *Seymour v. Spring Forest Cemetery Association, supra,* must overn.

Although petitioner argues at page 41 of its brief, hat "federal law controls the distribution to creditors n bankruptcy", it overlooks that there is—to use the language of this Court in the *Vanston* case—no "overruling ederal law".

The various decisions upon which petitioner relies for ts erroneous contention that there is a prevailing Federal aw or rule which proscribes the transactions here under onsideration, are all clearly distinguishable. What they old is that in the administration of an estate in bankruptcy "a local rule governing the liquidation of insolvent estates" will not be permitted to interfere with the nethod of distribution to creditors prescribed by the Bankruptcy Act."

Thus, in the case of *Prudence Realization Corp. v. Geist,* 316 U. S. 89 (1942), this Court refused to follow State law only for the reason that this law was found to e one "governing the liquidation of insolvent estates which was wholly at variance with the express provisions of the Bankruptcy Act."

In *American Surety Company v. Sampsell,* 327 U. S. 269, (1946), this Court sustained the order of the Referee subordinating the claim of the surety company because this was what State law required.

In *Heiser v. Woodruff,* 327 U. S. 726 (1946), the only point involved was whether a judgment of the State court would be regarded as *res adjudicata* in the Bankruptcy Court where it was shown that the Trustee in Bankruptcy had appeared in the State court proceeding and had taken

part therein. This Court held that the principle of *res adjudicata* would be applied.

Since petitioner and the Securities and Exchange Commission also rely heavily on the decision of this Court in *Pepper* v. *Litton*, 308 U. S. 295, it seems proper that we should point out that, in this Court's later decision in *Securities and Exchange Commission* v. *Chenery Corp.*, 318 U. S. 80 (1942), where the *Pepper* case was discussed, the prevention of fraud was held to measure the scope of the doctrine which the *Pepper* case was supposed to lay down. This Court then stated, in its discussion of the *Pepper* case, that it dealt merely with the question of whether claims obtained by the controlling stockholders of a bankrupt corporation were to be treated equally with the claims of other creditors where the evidence revealed "a scheme to defraud creditors reminiscent of some of the evils with which 13 Eliz. c. 5 was designed to cope". Although the *Chenery* case, when it came before this Court for the second time (332 U. S. 194) following a remission of the matter to the Securities and Exchange Commission, was decided adversely to the purchasers of the stock, nothing said in the second opinion of this Court affected its previous appraisal and interpretation of the rule laid down in *Pepper* v. *Litton*.

Certainly, nothing said in any of petitioner's authorities just reviewed justifies the position taken by petitioner on this appeal that in every bankruptcy case the question of what claims are to be allowed to share in the distribution is to be decided according to what the Bankruptcy Court in that particular case deems equitable—judged by its own standards and conceptions of equity—and that prevailing State law may be totally disregarded if it is contrary to what that particular Bankruptcy Court considers fair and proper. On this strange theory, every Bankruptcy Court would become vested with law making and rule making power that would run beyond anything heretofore known. Every District Court could apply its

own peculiar notions of equity—whether these conflict with the notions of other District Courts or with long established doctrines of the State Courts in that jurisdiction. There could never be any certainty or definiteness on any question and soon there would result the utmost confusion and chaos.

But even assuming for the sake of argument that the notions of petitioner are correct, it must be obvious that we do not have one body of equitable doctrines in the Federal courts and an entirely different body in the State courts. In the absence of a Federal statute, the Bankruptcy Courts, even if they have the right to allow or disallow claims on purely equitable considerations, must assess and appraise these considerations on the basis of the decisions of the highest State Courts in the jurisdictions where they are sitting. No other rule would be tolerable. The New York Courts have never regarded the purchase of securities by directors of a corporation as being wrong in principle, or otherwise objectionable, and this is true whether the corporation is solvent or insolvent.

POINT III.

Even if the insolvency rule pressed by petitioner does exist, it should not be applied in the case of a corporation which, though technically insolvent in the bankruptcy sense, is nevertheless a going concern.

Judge Goddard, in his opinion in the District Court, to which we have already referred (R. 94-95), pointed out that both under New York State law and even under the Federal decisions

> "directors and those who occupy a similar position may acquire the unmatured obligations of a going concern and enforce the same for the full face amount if such purchase is fair to the corporation

and involves no competition with the corporation • • •."

In addition to the cases which we have already cited, he referred to several others in support of his conclusion, viz. *Moore Constr. Co.* v. *U. S. Fidelity & Guarantee Co.*, 293 N. Y. 119, 125; *Ingelhart* v. *Thousand Islands Hotel*, 32 Hun 377; *Oelberman* v. *N. Y. & Northern R. Co.*, 14 Misc. 131.

Reviewing the authorities relied upon by petitioner where it was held that officers, directors and attorneys of a corporation may not—while the corporation is insolvent—purchase claims against it at a discount and then enforce such claims in a bankruptcy proceeding at their full face value, Judge Goddard pointed out that:

> "However, these cases do not seem to cover a situation where the corporation, although insolvent in a bankruptcy sense, is still a 'going concern' for the mere fact that a corporation is insolvent does not dissolve the corporation and make the directors mere trustees of its assets if it is still a 'going concern'. *White, Potter & Paige Mfg. Co.* v. *Pettes Importing Co.*, 30 Fed. 864; *Contra Costa Water Co.* v. *City of Oakland*, 113 P. 668, 682, 159 Cal. 323; *Public Market Co. of Portland* v. *City of Portland*, 130 F. (2nd) 624, 646, 171 Or. 522; *Michigan Wolverine Student Co-op* v. *Wm. Goodyear & Co.*, 22 N. W. 2nd, 884, 888, 314 Mich. 580. This distinction as to the duty of a director when the corporation, although insolvent is a going concern, was recognized in *Sanford Tool Co.* v. *Howe, Brown & Co.*, 157 U. S. 312; see *Asheville Lumber Co.* v. *Hyde*, 172 Fed. 730, 733."

We respectfully submit that even if, contrary to the uniform current of authority in New York State and in

the Federal courts sitting in New York, it should be held that so-called Federal law requires the recognition of the insolvency test here relied upon by petitioner, that doctrine should be held not to apply to a going concern.

Not only does the rule expressed by Judge Goddard accord with common sense and the elementary requirements of everyday business transactions, but it contains a definitely ascertainable standard of conduct which can be readily applied. It will be easy to enforce the sanctions imposed by the limitation doctrine when the proscribed purchases have been made after the corporation has ceased to be a going concern. There will never be any serious controversy as to when a corporation is a going concern and when it is not. When a corporation has closed down and has ceased doing business and paying its bills, it has entered upon a period of demise. While it maintains its property and assets and meets its bills—whether promptly or slowly is immaterial—it is still a going concern and there always exists the possibility of improvement and rehabilitation. Especially is this the case when the corporation is engaged in the real estate business and its solvency or insolvency depends upon market trends and currents in the real estate field.

Moreover, the rule expressed by Judge Goddard makes sense. While a corporation is a going concern there is no reason whatever to forbid directors from purchasing its securities when they think these are unduly depressed. First, such purchases insure a market for other security holders who do not want to or are unable to hold on to their holdings. Secondly, the purchase of such securities furnishes a powerful incentive to directors to work for the improvement and rehabilitation of their corporation because, if they are successful, they will reap a profit. To rob directors of going concerns which may be temporarily embarrassed of such a powerful incentive strikes us as being in the highest degree unwise. It is unnecessary and it would serve no possible purpose. If, as we

have previously pointed out, directors in the acquisition of debt securities overstep the mark and violate their fiduciary duties, they can always be called to account. Adequate safeguards therefore exist to prevent inequitable conduct by directors.

The instant case furnishes perhaps the best illustration that can be found of the force and validity of our contentions. As the Findings show, and as Judge Swan pointed out in his opinion, the conduct of the directors in this case was "obviously very beneficial to those debenture holders who retained and have proved their bonds in the arrangement proceeding" (R. 180). Unquestionably, this "obviously very beneficial" conduct was induced by the hope that this would enable the directors and the respondents to make their holdings of the debenture bonds more valuable and give them a profit on their investments.

If any such rule as petitioner argues for had existed during the critical years when the bonds here involved were being acquired, there would manifestly have been no possible incentive for the directors to even attempt to keep the debtor corporation alive or for the respondents to risk the monies which they advanced on the second mortgage and the taxes. Certainly, the hope of making a profit on the bonds which they purchased supplied a powerful motive to keep the debtor out of bankruptcy. None of the other security holders of the debtor corporation, large or small, were willing to put up one penny. And all of the other directors, who also held substantial quantities of the bonds, sought only to get rid of their holdings at any price they could get so that, as one of them put it, they would not have to attend the "funeral" of the debtor corporation.

How, then could the application of any such strict and rigorous rule as petitioner contends for have served any useful purpose in the case of a going concern like the debtor? Such a rule would only have defeated any pos-

ble chance of salvaging anything for the debenture olders here, and instead of the 43.61% which those who eld on received, there would have been a total loss to all. t will be recalled that the respondents, who advanced 15,000 on the second mortgage through their Baset Cororation for the purpose of staving off foreclosure of the rst mortgage by the Poughkeepsie Savings Bank in 1943, onorably refrained from foreclosing this second mortage when it went into default, and indeed advanced aditional moneys for taxes, amounting to about $8,000. It is uite clear that they would not have done so if they did ot own some of the securities of the debtor corporation. acking such ownership, there would have been no incenve whatever to withhold foreclosure of their second mortage. Because such incentive did exist, everybody beneted. And this is as it should be. Barring highly theretical arguments about the potential conflict in interest, o one in the practical realms of business life can see any eal or genuine danger in permitting directors to purnase the debt securities of their corporation even if the alue of the corporation's property falls below the lialities at any stage—so long as the corporation is able keep going and still has the prospect of being able to ork out of its temporary difficulties. By giving directors ome freedom of action and choice and affording them an pportunity to make a profit on securities which they purnase fairly while conditions seem bad, directors will act ith courage and vision and, in the end, all the security olders will benefit.

POINT IV.

The argument of petitioner and the Securities and Exchange Commission that purchases after insolvency by directors must be forbidden because such purchases are fraught with potential conflicts of interest is purely theoretical and without support in the actual experience of the business world. Moreover, any such rule is too vague and uncertain to be capable of enforcement, and there exists neither statutory nor judicial sanction for any such extreme position.

Petitioner studiously avoids any argument as to why a different rule should apply in the case of purchases of securities of insolvent corporations from that applying in the case of solvent corporations. Nor does petitioner present any reasonable or workable formula from which it could be determined how and when, in the case of a going corporation like the debtor, which managed to struggle through 13 years of existence and pay in full all of its current obligations as well as its mortgage indebtedness, directors desiring to buy the debtor's securities are at any given moment to determine whether the corporation is solvent or insolvent.

We have already discussed this matter at length at pages 9 to 11 of this brief and we have yet to find in any of the briefs submitted either by the petitioner or the Securities and Exchange Commission any answer to the practical questions and problems which inevitably must arise when an attempt is made to apply the suggested rule to such a case as the instant case or the *Wade Park Manor* case, *supra*.

The nearest that petitioner comes to any discussion of the merits of its contention here under review is at pages 20 and 21 of its brief where it makes some casual comment to the effect that "the impact of insolvency throws

upon the director the urgent duty of considering what steps are to be taken to protect the best interests of his corporation, its stockholders and its creditors"; and that "the conduct of directors, who are buying an insolvent corporation's debt securities at depressed prices, may make a substantial difference one way or the other to the corporation and its creditors." Petitioner goes on to ask:

> "What is to prevent directors from taking a certain line of action, or none at all, until they have corralled all of the debt securities they can? The directors of an insolvent corporation, faced with all the problems that insolvency creates, must keep themselves in a position where there will be no conflict of interest between their position as creditors and the welfare of the entire community of interests in the corporation. Claims which directors may have acquired when the corporation was solvent may, of course, present some conflict of interest once the corporation has become insolvent; but where after insolvency has occurred directors make purchases of claims they are deliberately creating the conflict."

This argument of petitioner follows in its entirety the contention advanced by the Securities and Exchange Commission in its brief *amicus curiae* filed in the Court of Appeals. The argument then made by the Commission was that "insolvency by its very nature places the corporation in the field to settle its indebtedness" and that any purchase of debt securities made from that time on by a director "is fraught with potential conflicts of interests".

First, it is to be observed that this same argument was advanced by the Securities and Exchange Commission to

this Court in the first *Chenery* case, 318 U. S. 80. There, too, the Commission emphasized that

> "the effect of trading by management is not measured by the fairness of individual transactions between buyer and seller, but by its relation to the timing and dynamics of the reorganization which the management itself initiates and so largely controls."

These contentions, however, did not impress the majority of the Court. Thereafter, the Commission again urged this same point of view in several other cases, including the *Wade Park Manor* case, but also without success.

Next, though the Commission urged that after insolvency "potential conflict cannot be avoided", the Commission has failed to present a single specific case where this supposed conflict actually arose. It is, of course, an easy matter to make a theoretical argument on any subject and it is a very simple thing to say that "potential conflict cannot be avoided" when insolvency ensues. More than bare assertions, however, are required to support such a novel viewpoint. The only clue that has ever been given as to just what potential conflict the Commission sees in the acquisition of securities after insolvency is the one mentioned in its brief in the Court below. There the Commission argued that since the acquisition of debt securities at a substantial discount may lead directors to postpone institution of proceedings under the Bankruptcy Act, without reference to the interests of the corporation, until they have had an opportunity to acquire the distressed securities, they should be forbidden in advance from ever getting into such a position. The Commission went on to acknowledge that a similar conflict of interest could exist in some situations where the corporation was technically solvent, but it offered no suggestions or proposals for dealing with that contingency. Certain it is that if the

foundation for the doctrine now pressed by the Commission rests upon the fear that directors of an insolvent corporation will postpone resorting to bankruptcy in order to corral all the debt securities they can, such fear is completely groundless. Common experience shows that the surest way to corral in the debt securities of an insolvent corporation at depressed prices is to plunge the corporation into bankruptcy or reorganization—not to keep the corporation running as a going concern. It certainly seems a naive view that directors will postpone bankruptcy in order to buy securities of their corporation more cheaply than they could acquire them after bankruptcy. If any actual case of that character ever existed, it is strange that the Commission has refrained from bringing it to the attention of the Court.

It surely must be of the utmost significance that no one except the Commission has thus far been able to discern the potential conflict just discussed. Up to the present moment, neither the Legislature of the State of New York nor Congress has sensed any such potential conflict and enacted statutory provisions to prevent it. Nor have the courts of New York State, which undoubtedly have more frequent occasion to deal with such matters than the courts of any other state, apprehended the existence of any such potential conflict. On the contrary, the Court of Appeals in the *Seymour* v. *Spring Forest* case, *supra*, thought that any rule prohibiting the purchase of the debt securities of a corporation by its directors while the corporation was a going concern would

> "crowd the rule almost to the verge of an absurdity, and to inflict a vital injury upon business interests by tainting with invalidity the holding by a director of the unmatured obligations of the corporation bought by him in the open market and not put in liquidation or sought to be extinguished."

And the able and experienced Federal judges in the Second Circuit who have had occasion to deal with this same question, some in the instant case and some in the other cases which we have cited, have also failed to apprehend the supposed danger that lurks in the continuance of business practices that have been going on without question or challenge for generations.

The Supreme Court of Wisconsin, in the case of *Glenwood Manufacturing Company v. Syme*, 109 Wis. 355, where the president and a director of a corporation acquired obligations of such corporation at a discount during a period when the corporation was "embarrassed and without funds to pay pressing demands" dismissed a suit brought against this president for an accounting of the profits which he had made and in its lengthy opinion made a critical analysis of the very doctrine which petitioner and the Commission expound here. In disapproving such doctrine, the Court pointed out that since there was no duty resting upon the president to extinguish the corporation's obligations and the corporation was obviously in no position to discharge these, there could be no conflict of duty which would prevent the acquisition of the corporation's obligations by the president for his own account.

Where Congress found on the basis of actual experience that some prohibition with respect to trading in the securities of an insolvent corporation was necessary, it did not hesitate to act (Sections 212 and 249 of Chapter X).

In a recent article published in the Harvard Law Review of June, 1949 (Vol. 62, No. 8) which reviewed the decision of the lower court in the instant case, the learned author after expressing his accord with such decision and after criticizing the so-called insolvency restriction, went on to make the following trenchant and sage observations:

"Moreover, since the general rule allowing directors to make such purchases is based on a choice in favor of allowing directors to have a stake in the corporate enterprise in spite of the danger that they will take unfair advantage of investors, it seems illogical to prevent directors from purchasing corporate obligations when the corporation is insolvent. That is the very time when such purchases may be of most benefit to the corporation, since the credit of the corporation may be improved if it is known that directors are purchasing the corporation's securities; also it may be possible to forestall a bankruptcy petition while the corporation improves its financial position. Cf. *Monroe* v. *Scofield,* 135 F. 2d 725 (10th Cir. 1943); see W. Fuller, *Restrictions Imposed by the Directorship Status on the Personal Business Activities of Directors,* 26 Wash. U. L. Q. 189 (1941). Thus it may be hoped that the present case indicates a trend away from the irrational insolvency restriction."

What responsible persons will ever agree to accept appointment as directors of such a corporation as the debtor corporation if they can never, during the continuance of the technical state of insolvency which petitioner claims existed, manifest their confidence in their ability to extricate the corporation from its difficulties by acquiring some of its securities for their own account. As we have already mentioned, if the argument of petitioner and the Commission in this case is pressed to its logical conclusion, none of the directors in this case nor their friends could ever have acquired any of the debentures because the debtor corporation was insolvent at the very beginning of its existence and at all times thereafter remained insolvent within the definition pressed by petitioner.

Buying orders, whether placed by insiders or outsiders, tend to support the market and enable investors who want

to get out and not assume any further risks to do so. Why should such orders be discouraged? No one need sell unless he wants to.

The Insolvency Restriction Doctrine Upon Which the Petitioner and the Securities and Exchange Commission Rely Is Unsound in Principle and Has Thus Far Failed to Receive Judicial Approval.

Neither the petitioner nor the Securities and Exchange Commission have undertaken to explore the genesis nor defend the rationale of the doctrine which they press upon this Court growing out of the insolvency restriction rule. Both have simply assumed that there is such a restriction and that it is a sound one.

In the dissenting opinion of the Court below, Judge Learned Hand likewise speaks of the books being full of declarations "that an insolvent holds his property in trust for his creditors" and that when the insolvent is a corporation whose directors were fiduciaries as to shareholders, they become double fiduciaries of the creditors on insolvency.

An examination of the decided cases, however, reveals that there is grave doubt that this insolvency restriction doctrine has any actual basis in the law. As the learned author of the article in the Harvard Law Review, to which we have previously made reference, points out:

> "It is generally held that a director of a solvent corporation may purchase corporate obligations at a discount and later enforce them for the face amount. See Ballantine, Corporations 209 (rev. ed. 1946). The present case (*Calton Crescent, Inc.*) extends this rule by rejecting the frequently stated restriction that a director may not enforce such obligation if the corporation was insolvent at the time of purchase. See 3 Fletcher, Cyclopedia of

Corporations §869.1 (repl. vol. 1947). This insolvency restriction has grown out of the theory that the assets of an insolvent corporation become a trust fund for creditors. See *In re Philadelphia & W. Ry.*, 64 F. Supp. 738, 740 (E. D. Pa. 1946). But the Supreme Court has refuted the idea that there is an actual trust relationship upon insolvency, *Hollins v. Brierfield Coal & Iron Co.*, 150 U. S. 371, 385 (1893), and it has been pointed out that the assets can be said to be a trust fund only by 'analogy and metaphor.' See 4 Pomeroy, Equity Jurisprudence §1046 (5th ed. 1941). The federal cases supposedly applying the insolvency restriction in fact involved a breach of duty by directors either because they were under a duty to acquire the obligations for the corporation, *e. g.*, *In re McCrory Stores Corp.*, 12 F. Supp. 267 (S. D. N. Y. 1935) (insolvent corporation was actively trying to settle its obligations), or because they had been appointed trustees in bankruptcy and so could make no profit. *In re Philadelphia & W. Ry.*, *supra*."

This Court, in the case of *Hollins v. Brierfield Coal & Iron Co.*, 150 U. S. 371 said, speaking upon this trust fund doctrine (p. 385):

"These cases negative the idea of any direct trust or lien attaching to the property of a corporation in favor of its creditors, and at the same time are entirely consistent with those cases in which the assets of a corporation are spoken of as a trust fund, using the term in the sense that we have said it was used. * * *

A party may deal with a corporation in respect to its property in the same manner as with an individual owner, and with no greater danger of being held to have received into his possession property

> burdened with a trust or lien. The officers of a corporation act in a fiduciary capacity in respect to its property in their hands, and may be called to an account for fraud or sometimes even mere mismanagement in respect thereto; but as between itself and its creditors the corporation is simply a debtor, and does not hold its property in trust, or subject to a lien in their favor, in any other sense than does an individual debtor. That is certainly the general rule, and if there be any exceptions thereto they are not presented by any of the facts in this case. Neither the insolvency of the corporation, nor the execution of an illegal trust deed, nor the failure to collect in full all stock subscriptions, nor all together, gave to these simple contract creditors any lien upon the property of the corporation, nor charged any direct trust thereon."

In the recent opinion filed by Special Master Friebolin in the *Matter of Wade Park Manor Corporation, supra,* which we have discussed, he pointed out that much of the confusion respecting the duties and obligations of directors arises from the failure to recognize the nature of the fiduciary relationship. We quote from the learned Special Master's opinion:

> "The law seems to be that a director's relation to his corporation is that of a fiduciary with rather strict duties as to loyalty; that, altho he is a fiduciary in his relation to *stockholders,* he may ordinarily buy and sell its stock, except under special circumstances of unfairness in the particular transaction.
>
> No contention is here made that a director of a corporation *at all times* sustains a fiduciary relation to *creditors;* it is claimed that upon 'insolvency' the director becomes such fiduciary, particularly insolvency in the bankruptcy sense.

If that be conceded, we still have the question in that particular fiduciary relationship, what are the duties and responsibilities of a director towards creditors; the beneficiaries? Is it the strict rule applicable to express trustees? Are they bound by the strict rule of undivided loyalty in all circumstances, regardless of good faith and honest dealing? Or are they bound by the less rigid rules: good faith, fair dealing and no inequitable conduct conflicting with a present duty to the corporation or to creditors?

The objectors in the case before us contend that, once the corporation is insolvent in the bankruptcy sense only, directors become, in effect, express trustees; any dealing in claims of creditors is a violation of the strict duty of loyalty; good faith, honest intentions, no suppression of facts to the sellers who offered their securities for sale for the public to buy, has any relevance. The fact that this insolvency existed for fourteen years before proceedings were instituted and that such claims (bonds and Land Trust Certificates) were bought and sold by public brokers for many years at the market price, it is said, has no relevance."

The Securities and Exchange Commission filed a brief with Special Master Friebolin in which it advanced the same arguments that are advanced here. Commenting upon these arguments, the learned Special Master said that while they possessed "no little force" he could not find that the Courts have gone so far as to apply the extreme doctrine urged. He said:

"I cannot find that the courts have gone so far as to apply to the fiduciary relationship of a director as to creditors, that of a strict trustee; nor even to hold that, as a fiduciary of creditors merely

because the corporation at the date of purchase by him of claims against the corporation was insolvent in the bankruptcy sense, he is then accountable within the strict rule of an express trustee.

It must be kept in mind always, of course, that even tho a director be not bound by the strict rules of a trustee; even tho he might conceivably not be found to be a 'fiduciary', the Bankruptcy Court may nevertheless in the exercise of its equitable jurisdiction, sift the circumstances surrounding any claim to see that injustice or unfairness is not done in the administration of an estate. Particularly where the court finds a person to occupy a fiduciary position, his claim may, upon equitable grounds, be subordinated or limited. The Supreme Court has on several occasions announced this rule."

It will be obvious from the foregoing that much of the confusion respecting the duties and obligations of directors arises from the failure to recognize the nature of the fiduciary relationship. If a director occupies the position of an express trustee so that he is strictly forbidden under any circumstances to purchase the unmatured obligations of his corporation when it is insolvent in a bankruptcy sense, his liability with respect thereto is then absolute and all questions of good faith, fair dealing, or conduct hostile to the interests of the corporation and its creditors, become irrelevant. No reported decision has ever so held. (See decision of Judge Patterson in *Ripperger* v. *Allyn*, 25 Fed. Supp. 554, at p. 555.) On the other hand, if the fiduciary duty of a director, after insolvency in the bankruptcy sense, rests upon the equitable principles governing constructive trusts, then the accountability of a director is not absolute but depends upon whether the purchases were made under circumstances

hich in the conscience of equity may be regarded as unist enrichment.

Thus, the nature of a director's fiduciary duty—whether is governed by the rules applicable to express trusts or e rules applicable to constructive trusts—is basic to the ecision here on appeal and is basic to a clarification of e law. With respect to this fundamental question, to old that a director is in effect an express trustee, absent ny manifestation of corporate intent to make him such, ould be contrary to the well established rules governing xpress trusts. It would create a violent disturbance in e common practices of business. In many cases, as ere, it would result in the unjust enrichment of other editors who have suffered no injury. Where purchases f unmatured bonds of a going concern were made by a rector long before bankruptcy proceedings, it would resent difficult questions of fact as to the fair value of e corporate assets at the time of the purchases and ould present difficult questions of fact as to the time hen bankruptcy insolvency occurred and as to whether ich insolvency was continuous to the date of the bankiptcy filing. The alternative is to hold that in the case f all claims by a director the right to participate ratably bankruptcy proceedings depends upon a determination at the director was not guilty of fraud, bad faith or inquitable conduct conflicting with any present duty to his rporation, its creditors or stockholders; and as an examination of the cases shows, this has been the practice tually followed by the Federal Courts, despite the occaonal language in some of the cases ambiguously charterizing the position of a director as that of a trustee, hile at the same time relying upon the powers of the ankruptcy Court to distribute the estate acording to its wn equitable rules, as announced by this court in *Pepper Litton*, 308 U. S. 295, and subsequent cases.

We shall later consider the authorities relied upon by e petitioner and the Securities and Exchange Commis-

sion. We think it will be clear from our review that wherever the insolvency restriction was applied, the corporation involved has ceased to function as a going concern and there existed actual breaches of duty on the part of the directors. If that is so, then, these cases manifestly furnish no authority against the decision here under appeal.

The Application of the Insolvency Restriction Doctrine to the Case of a Going Concern Would Be Opposed to Common Sense.

Finally, it is to be observed that even if the Commission's viewpoint has any substance or force, it can only be in relation to a business that has for all practical purposes been shut down and is virtually in process of liquidation—not to a going concern like the debtor which continues to retain its property and carry on its business and meet its current obligations. Such a going concern—even if technically insolvent, stands, from every practical standpoint, in no different position than a solvent business. As has already been pointed out, the debtor's issue of debenture bonds did not mature until September 27, 1953, and no interest was payable thereunder unless earned. There was, therefore, no need for the directors of the debtor corporation to deal with the problem of paying or composing this bond issue until the property had been sold and determination made as to whether sufficient remained to pay the bonds off in full. That did not occur until 1946. Until then the debtor stood in the same position as any solvent corporation. It operated its business and paid its bills—though sometimes late, and it retained ownership of its sole asset. Indeed its situation was constantly improving, due to the fact that construction of new housing had stopped during the War and inflation was on the wing. At no time up to an actual sale could the question of whether it was insolvent or solvent be

strated objectively, and no need ever arose to deal
hat problem until the sale which took place in 1946.
inly, the petitioner and the Commision have failed
ighten the Court as to where and when the sup-
potential conflict of interest, of which they speak,
in the instant case. If the Commission's argument
nd that this arose on insolvency, then two difficul-
t once present themselves. The first is that the
ration was born insolvent and the second is that
r legal nor practical insolvency could be spelled out
the mere fact that the debtor's property could not
times here material have been sold in the market
price sufficient to pay all the debts. At times, there
no market even for the choicest properties, and
cannot be sold at anything except distress prices.
however, does not mean that the owner of the prop-
who is meeting all his current obligations and carry-
arges has become insolvent in any practical sense
at a duty immediately rests on him to consider the
ation of some kind of debtor proceeding.

POINT V.

**any aspect of the matter, the unanimous opinion ex-
d by the Referee, the District Judge and all three
s of the Court of Appeals, that the purchases made
e respondents from other directors of the company
l not be subject to any limitation rule, is sound and
l be affirmed by this Court.**

e extremes to which the petitioner goes in its con-
ns is best exemplified by its insistence that even on
ecurities acquired from other directors, the respond-
should be deprived of any profit. On this point the
ee and all of the Judges who have sat on the in-
case are fully agreed that no rule of law or prin-

ciple of equity or controlling decision warrants or justifies any such holding. Even Judge Learned Hand, in his dissenting opinion said (R. 188):

> "I should not include any bonds bought by a director from a director; surely they stand on an equality."

We have already reviewed at page 7 of this brief the negotiations which led up to the sale by the former directors and officers Kelly, Hays, Clay, representing the Y. W. C. A.) and Minor (representing the King Estate) of their holdings, and we have shown that these parties, without solicitation and entirely on their own initiative, bargained with the respondents to purchase their securities from them so that they could completely terminate all connection with the debtor corporation. That these other directors had full and complete knowledge of the affairs and operations of the debtor corporation was overwhelmingly established (F. 44, 45, 47, 50, 51, R. 76-77), Respondents' Exhibits 7, 8, 9, 10, 11, 16, 17, 22, 23, 24, 25b, 25e, 29, R. 146-163). And even petitioner concedes, at page 13 of its brief, that all of these other directors knew that they were selling their bonds to respondents.

In view of the foregoing, it is impossible to fathom what rule of equity petitioner claims was violated by respondents in purchasing these securities from the other directors two years before bankruptcy. It certainly cannot be argued that these directors, men of eminence and standing in the financial and legal world, were imposed upon or overreached or that they did not know what they were doing. None of them came forward on the trial of this case and made any such complaint. Petitioner, however, does gratuitously suggest at page 13 of its brief that these directors may not have been informed of the inquiries and offers which were being received for the real

tate. Strange it is that petitioner called none of these rectors as witnesses to prove this unjust assumption. oreover, petitioner ignores the holdings in all of the inions in the courts below, including the dissenting opin- n of Judge Hand, that the petitioner's case broke down mpletely so far as it rested upon the suppression of any formation with regard to the value of the property.

Certainly, if the rule of law contended for by the titioner is so strict that it even bars directors of a rporation from selling to other directors or friends or embers of the families of these other directors, it would ach the point of absurdity and injustice. No wonder titioner has refrained from advancing the least argu- ent to support this extreme claim on its part. That y such claim is completely devoid of merit seems to be early established (*Bisbee* v. *Midland Linseed Products* ., 19 Fed. [2d] 24, [C. C. A. 8, 1927]; *DuPont* v. *Du- ont*, 256 Fed. 129 [C. C. A. 3, 1919]).

POINT VI.

None of the cases cited by petitioner or the Securities d Exchange Commission are applicable and all of them ll within the well recognized exceptions to the general le.

The authorities relied upon are: *In re Van Sweringen ompany*, 119 Fed. (2d) 231 (6 Cir. 1941); *In re Norcor anufacturing Co.*, 109 Fed. (2d) 407 (7 Cir. 1940); *Mon- e* v. *Scofield*, 135 Fed. (2d) 725 (10 Cir. 1943); *In re os Angeles Lumber Products Co. Ltd.*, 46 Fed. Supp. 77). C. S. D. Cal. 1941); *In re Jersey Materials Co.*, 50 ed. Supp. 428 (D. C. N. J. 1943); *Philadelphia* v. *West- n Ry. Co.*, 64 Fed. Supp. 738 (D. C. E. D. Pa. 1946); *re McCrory Stores Corporation*, 12 Fed. Supp. 267). C. S. D. N. Y. 1935); *Ripperger* v. *Allyn, et al.*, 25

Fed. Supp. 554 (D. C. S. D. N. Y. 1938); *Bulkley* v. *Whitcomb,* 121 N. Y. 107 (1890); *Bramblet* v. *Commonwealth & Lumber Co.,* 26 Ky. L. Rep. 1176 (1904); *Bonney* v. *Tilley,* 109 Cal. 346 (1895).

When these cases are analyzed, they will all be found to fall within one of the well recognized exceptions to the rule applied below which permits directors to buy securities of their corporation—whether solvent or insolvent—and to prove their claims for the full face amount of such securities.

Referee Olney in his opinion pointed out (R. 79) that there exist certain well recognized exceptions to the rule of law which he applied in favor of the respondents. These exceptions relate to cases (1) where a special fund has been provided by the debtor corporation to pay the obligation; (2) where a special liquidation has been ordered through the institution of receivership or kindred proceedings; (3) where the debtor was in the field to settle its own obligations; (4) where the acquisition of the obligation by the director was unfair to the debtor and involved competition with it; and (5) where the director is guilty of overreaching by unfairly using his special knowledge in dealing with those from whom he acquired the obligations.

Judge Goddard, in his opinion in the District Court, also recognized the existence of these exceptions (R. 94-95).

The principal authority relied upon by petitioner and the Commission is, of course, *In re Van Sweringen Company, supra.* The facts of this case, as given by petitioner at pages 22-23 of its brief, are wholly inadequate. What was there involved was a reorganization under former §77-B. The debtor corporation had pledged virtually all of its assets with J. P. Morgan & Co. to secure loans exceeding $39,000,000 in amount, for which promissory notes were given to the said pledgee. These notes went into default and the Morgan Company gave notice

at it would sell the collateral at auction. By that time, f course, the debtor corporation had completely ceased oing business as a going concern. The Van Sweringen rothers, who were officers and directors, designing to cquire control of the pledged assets for themselves and freeze out all of the creditors of the corporation, conived with two individuals named Ball and Tomlinson to rm a corporation known as the Midamerica Corp., which ould buy in these pledged assets at the auction sale at ridiculously low price. This was successfully accomlished and then the Midamerica Corp. proceeded to file a aim in the reorganization proceeding for the face amount f the notes which it had acquired at the auction sale nducted by the pledgee, Morgan & Co. The grossly agrant character of the transaction was marked by the ct that although the Midamerica Corp. had on its own ooks allocated only $1.00 of the price paid on the auction le for the note of the debtor corporation in the amount f $8,177,023.99 and had allocated only $887 as the cost f another note in the face amount of $13,787,000, and 2.00 as the cost of a still further note of the debtor's ubsidiary, Cleveland Terminals Building Company, in the nount of $1,348,614.99, it nevertheless proceeded to file aims against the debtor corporation for the full face nount of these large obligations,—and this notwithanding the fact that it had already acquired at the sale l of the collateral security which was deposited to secure ese obligations. This same Midamerica Corp. it deeloped, had agreed by contract to give the Van Sweringen Bros. a ten year option to acquire 55% of the stock the Midamerica Corp. at cost, plus 5% interest, and so agreed to pay them a salary of $100,000 a year. The t result of the transaction, as the Court pointed out, as that without investing a penny the Van Sweringen ros., who as officers and directors of the debtor corpotion occupied a fiduciary relationship to their creditors, me out of the affair with complete voting control of the

Midamerica Corp. for ten years; a $100,000 annual s ary, and an option to buy 55% of the stock of the Mi america Corp. for $8,250.

Certainly, the attempt not only to retain the pledg securities of the debtor corporation purchased at the au tion sale but to file for the full face amount of the debto notes which were secured by these pledged securities, w a shocking performance which no court could countenan It was a fraud which a Bankruptcy Court had full pow to deal with not only under the provisions of former S tion 77-B, but also under the inherent power to preve fraud recognized in *Pepper* v. *Litton*, 308 U. S. 295. T Court, citing the *Pepper* case as authority, pointed o that what the Midamerica Corp. did was "within the i hibited area of bargaining not conducted at arm's leng as defined in *Pepper* v. *Litton*." The Court went on say that it was apparent "that the cupidity of persons a fiduciary position has caused them to serve themselv in preference to those whom it was their duty to serve

Manifestly, the facts in the instant case are whol dissimilar from the facts in the *Van Sweringen* case. the very outset we find in the *Van Sweringen* case a pu chase of assets of the debtor corporation—not mere debt securities. It was the collateral securing the debto notes which was offered for sale at auction and which t Van Sweringen Brothers bought in through their cre ture, Midamerica Corporation. Next, the Van Swering Brothers, who, as officers and directors, owed the high degree of loyalty to their creditors, persuaded Ball a Tomlinson to join with them in violating their fiducia obligations in a manner which would yield a profit to bo Contrast that situation with the instant case where assets of the debtor corporation were involved in the se eral purchases (but only debt securities) and where no of the directors had any financial interest in the secu ties acquired. Furthermore, whereas in the *Van Swer gen* case the purchases were made after the corporati

had ceased doing business and its assets were being sold under the hammer, and when an insolvency proceeding was obviously imminent, the purchases in the instant case were made while the corporation was functioning normally as a going concern and the purchases were made months and years before the arrangement petition was filed.

An excellent discussion of the decision in the *Van Sweringen* case is to be found in the opinion of Special Master Friebolin in the *Wade Park Manor* case. He there said in part:

> "The objector and the Securities & Exchange Commission rely upon the *Van Sweringen* case (6 C. A. 41) 119 F. 2d 231. They claim that in this case the Court applied to directors the strict rule applicable to Trustees, that is, undivided loyalty which does not take into account good faith and fair dealing or the rules of unjust enrichment applicable to persons other than express trustees who are fiduciaries. The claimants herein, on the other hand, insist that the Court did no such thing; that it found fraud and lack of good faith.
>
> I am inclined to agree with the claimants. It should not be overlooked that the Court of Appeals decided several separate proceedings in one opinion. These originated with a report by a Special Master to the District Court followed by a decision and opinion by that Court upon each of the said reports. I have read the Master's Reports, both opinions by Judge Jones, in which he approved one Report by Special Master Russo—in which the claim was disallowed—and disapproved the other Master's report by Mr. Woods—in which the claim was allowed.
>
> After reading the two opinions by Judge Jones and the opinion of the Court of Appeals, I am quite

convinced that the court did not apply the rule contended for by the objectors to the effect that the directors of a debtor became trustees for creditors merely upon the bankruptcy insolvency of the debtor, with the duty of undivided loyalty applicable to strict trustees so that good faith to, and fair dealing with, creditors is immaterial, and that the rules of unjust enrichment found by inequitable conduct, are entirely irrelevant.

There are many statements in the two opinions of the District Judge and of the Court of Appeals, which seem to indicate quite clearly that there was found bad faith and inequitable conduct by directors of the debtor which the Court, within exercise of its equitable powers, regarded sufficient to make Midamerica (the corporation organized at the instigation of the directors for the purpose of purchasing the notes and bonds of the debtor and the subsidiary debtor) a constructive trustee of the property."

In the case of *In re Norcor Manufacturing Co., supra*, the claims against the bankrupt corporation were purchased not only by Kreuger, the principal stockholder and director, but also by his attorney Lehner, as well as by Lehner's wife. All these claims so purchased were then reassigned to a corporation whose board of directors were controlled by Kreuger and Lehner. The claims were purchased after the bankrupt corporation had already confessed insolvency in the Court, and they were acquired in contemplation of an impending reorganization.

Clearly, this *Norcor* case falls within one of the well recognized exceptions to which we have referred. The purchase was made ten months after an insolvency proceeding had been started in the State court and the Court found that the conduct of Kreuger and his attorney was fraudulent.

The case of *Monroe v. Scofield, supra,* also falls within one of the well recognized exceptions. The purchase attacked was made by a director after bankruptcy and the Court held that this could not be done except "by an order of the Court" and then not unless Monroe had "been shorn of all power in the corporate management and his trust relationship has been fully terminated".

The case of *In re Los Angeles Lumber Company, Ltd., supra,* also falls within one of the well recognized exceptions. An excellent statement of what this case really held is to be found in the report of Special Master Friebolin in the *Wade Park Manor* case. He there said:

> "In the *Los Angeles Lumber* case directors and their attorney purchased most of the bonds of their corporation after the filing of a reorganization petition, but a few, also, before such filing. But the latter were purchased *after the Board of Directors of the debtor corporation had authorized the filing of such petition* and while the debtor was insolvent —apparently both in the bankruptcy and equity meaning, altho the court doesn't say so. The court regarded the reorganization (was) *really in process at the time* and limited the allowance to cost of acquisition. As appears from the opinion, the Court relied, also, on the general equitable powers of the Bankruptcy Court to limit, disallow or subordinate claims to prevent injustice and unfairness, especially when a fiduciary relation exists—regardless of the rules applicable to strict trustees. After a court takes possession of the debtor's property the strict rule applicable to express trustee seems to be enforced—certainly where the debtor is in possession."

It is also interesting to note that the decision of the Federal District Court in the *Los Angeles Lumber* case

was based upon two California decisions cited by the Court at page 88, thus indicating that the Court was applying a rule of local application.

In its discussion of the facts in the *Los Angeles Lumber* case, petitioner at page 28 of its brief mentions that the "early purchases were made before any reorganization proceedings were pending". But petitioner fails to mention that such purchases were made after the Board of Directors had authorized the filing of the petition; when the corporation was no longer a going concern, and when insolvency both in the bankruptcy and equity sense existed.

The case of *In re Jersey Materials Co., supra,* also falls within one of the well recognized exceptions. The purchase by the President and his dummy was made when bankruptcy was not only imminent but in contemplation. In the language of Special Master Friebolin, who discusses this case in his report, "the court expressly found that the director did *not* fairly execute the duties of his trust; he *anticipated dissolution* of the corporation and knew that the mortgage could be bought at a bargain and *failed to communicate it* to the corporation.

The case of *Philadelphia* v. *Western Ry., supra,* also falls within one of the well recognized exceptions. The purchases were made after a 77-B reorganization proceeding had been initiated and during the period when the debtor corporation was in possession under orders of the Court. The Court pointed out that "directors holding office under court appointment or court approval become in all respects, so far as their fiduciary obligations are concerned, the full equivalent of a trustee in bankruptcy."

The cases of *In re McCrory Stores Corporation,* and *Ripperger* v. *Allyn, supra,* have already been discussed at pages 48 and 49 of this brief. The limitation which was enforced in the *McCrory* case was under the scrutiny clause of former §77-B (11 U. S. C. A. §207 [b]). Judge Patterson found that there had been a violation of fiduciary

obligation on the part of Hedden who, while he was a director of the debtor corporation, obtained information with respect to the various leases and the claims of landlords arising thereunder, which information he utilized immediately upon his resignation. The *Ripperger* case arose on a motion to dismiss the complaint but the Court explicitly pointed out the immunity doctrine does not apply where the failure of the debtor company to buy up the claims for itself was brought about because the directors wished to acquire them for themselves.

The case of *Bulkley* v. *Whitcomb*, *supra*, is completely inapplicable, as we show on page 50 of this brief.

The case of *Bramblet* v. *Commonwealth & Lumber Co.*, *supra*, is also a case falling within one of the recognized exceptions. The Court there found that at the time of the purchase of the judgment by the President, acting in collusion with another, the corporation "was a derelict and its assets salvage". The Court found bad faith, collusion and violation of fiduciary obligation.

The case of *Bonney* v. *Tilley*, *supra*, involved an effort on the part of directors of an insolvent corporation, who were creditors, to obtain a preference over other creditors by buying up some judgments against the corporation for nominal amounts. The Court said:

> "It seems to be well settled that directors of an insolvent corporation, who are creditors of the company, cannot secure to themselves any preference or advantage over other creditors in the payment of their claims."

5

POINT VII.

There is no authority for the filing of a limitation proceeding by one creditor to reduce the claim of another creditor in an arrangement proceeding under Chapter XI.

Admittedly, there is nothing in Chapter XI which authorizes the filing of a limitation proceeding to reduce claims to amounts paid therefor. This is readily understandable when we consider the nature of a Chapter XI proceeding, which is nothing but a substitution for the old type of composition under former §12 of the Bankruptcy Act. That, as was pointed out by Judge Leibell in the case of *In re Vulcan & Reiter Co.*, 8 Fed. Supp. 286 (S. D. N. Y.), "in effect" was "a contract between the debtor and his creditors by which he obtained a settlement of their claims against him by paying an agreed sum into court for distribution to such creditors by order of the court. * * * The rights of the debtor and the creditors became fixed as of the date of confirmation, and nothing more remained to be done but the distribution of the fund."

This same view was taken by this Court in the case of *Nassau Works v. Brightwood Co.*, 265 U. S. 269 (1924), at page 271, and by the Court of Appeals for the Second Circuit in the case of *Equitable Holding Corporation v. Woody*, 63 Fed. (2d) 751 (1933).

Since, in the case of a composition, the contract of the debtor is to pay to the creditor an agreed sum in settlement of the latter's claim, it is obvious that creditors have no standing to file objections to the claims of other creditors and that only the debtor would have such right. There is no reported case that we have been able to find where, in the old fashioned composition proceeding under §12, or in an arrangement proceeding filed pursuant to Chapter XI, creditors have been permitted to come into

ourt and limit the claims of other creditors, so that they ght obtain an increased dividend beyond what the btor agreed to pay. It is surely significant that Coness, although writing a limitation provision covering aims and stock into the provisions of Chapter X yet iled to do so in Chapter XI. Petitioner has advanced explanation or argument touching upon this significant nission. And even in Chapter X, the only statutory anority for a limitation proceeding is to be found in §212. it this section appears to confine the power of the Court limit claims in a corporate reorganization proceeding claims or stock acquired by a committee, indenture ustee, attorney, or agent acting under or proceeding ider a power or warrant of attorney, trust mortgage, ust indenture, or deed of trust. Certainly, therefore, en if the instant case was a reorganization proceeding ed under Chapter X, it is doubtful that petitioner's moon for limitation of the claims of the respondents would proper—absent, of course, fraud or wrongdoing cogzable under the doctrine of *Pepper* v. *Litton*, *supra*. As matter of fact, all of the cases relied upon by petitioner, nere limitation proceedings have been entertained,—with e exception of *Monroe* v. *Scofield*, 135 Fed. (2d) 725 943), and *In re Jersey Materials Co.*, 50 Fed. Supp. 428 943)—will be found to be reorganization cases either ider Chapter X or former §77-B. The *Monroe* and *rsey Materials* cases were both ordinary bankruptcy oceedings involving flagrant violations of fiduciary duty officers or directors of the bankrupt corporations, hich were committed, in the one case, while bankruptcy as pending in the court, and in other case in contemplaon of bankruptcy.

In short, there is no statutory authority or judicial pinion—state or federal—which justifies the limitation oceeding in this case.

Manifestly petitioner is proceeding on the assumption at a Bankruptcy Court had inherent power as a Court

of Equity to limit claims in any kind of a bankruptcy or reorganization proceeding. The question immediately arises: Why, if the Bankruptcy Court has inherent power to limit claims, was it necessary to legislate express power so to do in Chapter X and to confine such power to the specific situation dealt with in §§212, 249.

The case of *Vanston Bondholders Protective Committee v. Green*, 329 U. S. 156 (1946), is cited by petitioner to support the view that the Bankruptcy Court has power to limit the allowance of claims in a manner that would "be compatible with the Bankruptcy Act." It is, of course, true that this language was used and that at a later part of the opinion this Court when on to say that Bankruptcy Courts "must administer and enforce the Bankruptcy Act as interpreted by this Court in accordance with authority granted by Congress to determine how and what claims shall be allowed under equitable principles." However, in this very same opinion, the Court pointed out that:

> "What claims of creditors are valid and subsisting obligations against the bankrupt at the time a petition in bankruptcy is filed is a question which, in the absence of overruling federal law, is to be determined by reference to state law."

CONCLUSION.

It is respectfully submitted that the order appealed from should be in all respects affirmed.

Dated, New York, October 13, 1949.

Respectfully submitted,

David W. Kahn,
Counsel for Respondents.